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# Regulating Public Employee Retirement Systems for Portfolio Efficiency

Marcia Gaughan Murphy

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# Regulating Public Employee Retirement Systems For Portfolio Efficiency

Marcia Gaughan Murphy\*

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\* Associate Professor of Law, Case Western Reserve University.

## I. INTRODUCTION

This Article develops a model regulatory scheme for public employee retirement systems by examining the relation between the legal theory, structure, and mechanics of such systems and the performance of those who regulate and manage them. The Article focuses on the regulation of public pension fund investment, rather than on benefit and funding policy. Pension plan benefits are funded by employer contributions<sup>1</sup> and the income generated through their investment. Contributions must increase or benefits decrease, or both, if fund investments fail to produce the return needed to make the promised payments. Thus, proper management of fund assets is essential if the promised benefits are to be provided within the established contribution rates. This is especially true in public pension systems where political and legal constraints are likely to impair the ability of management to reduce employee benefits or to increase government contributions through higher tax rates. Another reason to focus on the control of plan funds is the increasing attention public plan assets are receiving as a potential source of money to finance social welfare projects.<sup>2</sup>

Part II of this Article explores the proper objective(s) of public pension fund regulation. Part III examines the regulatory legal framework of two state pension systems<sup>3</sup> and identi-

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1. Public pension plans also may be funded in part by employee contributions.

2. See *infra* note 12. A recent study issued by the Urban Institute reports that state and local pension plan assets equal almost two hundred billion dollars and are increasing by more than twenty billion dollars each year. [1981] 338 PENS. REP. (BNA) A-10. Social investing proponents have succeeded in introducing measures in Congress permitting the use of pension funds to finance social welfare improvements. See, e.g., H.R. 6525, 96th Cong., 2d Sess., 126 CONG. REC. H914 (daily ed. Feb. 13, 1980).

3. The Article uses Minnesota as a primary case study of the regulation and operation of public pension funds and the Ohio School Employees Retirement System as a second case study to compare and contrast with Minnesota. Minnesota is an especially appropriate state to use as a case study of public employee retirement system regulation for several reasons. Over the years, Minnesota has evolved an institutional structure aimed at reducing the local political pressures inherent in many of the local public employee plans by consolidating the investment of many of its state and local public employee retirement funds in a constitutionally created State Board of Investment. See MINN. STAT. § 11A.23 (1980). The Minnesota structure, as it has evolved, is geared to vesting investment power and activities in the hands of financial and investment experts who are politically accountable. See MINN. STAT. § 11A.03 (1980) (State Board of Investment consisting of five constitutional officers); MINN. STAT. § 11A.07 (1980) (experienced investment professional as executive direc-

fies major inefficiencies in fund regulation. Part IV draws on the conclusions in parts II and III to suggest a model framework for the regulation of public pension fund management aimed at effectuating portfolio selection efficiency.

## II. THE PROPER CONTROL OBJECTIVE OF PENSION FUND INVESTMENT

### A. PURPOSE AND NATURE OF PUBLIC EMPLOYEE RETIREMENT SYSTEMS

A determination of the proper objective(s) of public pension plan investment regulation logically begins with an analysis of the purpose and nature of public pension retirement systems. The primary reason for the establishment of pension plans, whether public or private, is to provide employees with a source of income during retirement. Retirement income in the United States comes from three principal sources: federal social security old-age payments, personal savings, and employer retirement programs.<sup>4</sup> Employer pension plans developed as

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tor); MINN. STAT. § 11A.08 (1980) (Investment Advisory Council comprised of individuals experienced in general investment matters). Recent statutory changes have placed Minnesota among those states which are broadening the investment horizons of their pension plans in an attempt to take advantage of the increased return available through nontraditional investment vehicles and asset mixes. See MINN. STAT. § 11A.24(6) (Supp. 1981). Furthermore, legislation proposed in Minnesota, S.F. 452, 72d Sess. (1981), squarely raises the "social investing" issue which is currently being debated by politicians, fund administrators, unions, scholars and various interest groups in an increasing number of states. See *infra* note 12. Finally, recent events have placed Minnesota on the brink of a transitional period which may encompass fundamental changes in the philosophy and control of the system's policy formulation, management, and performance review. See *infra* note 107. The problems facing the Minnesota system, the issues which are currently being debated, the proposed solutions, and the responses of those involved with the plans seem certain to have implications for public employee pension systems throughout the United States.

4. In a statement before the President's Commission on Pension Policy, D. Grubb commented:

Every American should retire with an adequate retirement income. Many of us were nurtured on the idea that such an income rests on a three-legged stool of social security, employer retirement programs and individual savings. . . .

Projections by the Social Security Administration indicate that the median worker retiring at age 65 will receive a primary insurance amount equal to 41% of his preretirement income. While this is of substantial assistance, by itself it does not provide an adequate retirement income. This is why most of us are advocates of an employer retirement program to supplement social security. . . .

D. Grubb, Statement before President's Commission on Pension Policy (June 22, 1979), reprinted in [1979] 246 PENS. REP. (BNA) R-28. See also *Summary of*

an integral component of the nation's retirement system to fill the gap between the level of income needed for employees to maintain an adequate standard of living during retirement and the level of income provided by social security and personal savings.<sup>5</sup>

To the extent that employees forego higher wage levels or make mandatory contributions to a retirement plan fund in exchange for income during their retirement years, employer retirement programs serve as a means of deferring compensation. Particularly in the public sector, employees have historically been paid less in wages but more in retirement benefits.<sup>6</sup> The growth of collective bargaining for pension rights has increased the use of retirement benefits as a form of deferred compensation.<sup>7</sup>

Most public retirement systems provide for the timely payment of pension benefits by accumulating and investing a fund of assets in advance of employee retirements.<sup>8</sup> There are two principal reasons for the use of advance funding of public pen-

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*Report of 1979 Advisory Council on Social Security*, [1979] 270 PENS. REP. (BNA) R-1. The summary stated:

The social security programs are but one part of a complex set of public and private approaches to income maintenance. Support is available from four basic sources when earnings stop: social security based on past earnings; savings, insurance, annuities, and other voluntary personal arrangements; private pensions; and public programs based on current need. The council believes that the social security program must always be viewed in the context of these other important elements of the income maintenance system.

*Id.* at R-6.

5. More than two million people receive retirement benefits from public pension plans and another nine million workers are covered by such plans. [1981] 338 PENS. REP. (BNA) A-10.

6. The author of a major study of public employee retirement systems points out that "[p]rivate wage-and-salary levels outstripped the public levels during World War II and its aftermath . . ." R. TILOVE, *PUBLIC EMPLOYEE PENSION FUNDS* 79-80 (1976). Public employees have argued that underpayment during employment justifies pensions higher than those of private sector employees. *Id.* at 4-5. The survey concluded that public retirement plans provide an average benefit level higher and more generous than private plans. *Id.* at 49, 67. It should be noted, however, that public employee salaries have been competitive with private industry since 1967. *Id.* at 80.

7. Although public pensions are not in fact collectively bargained in many states, "[r]etirement benefits are obviously part of remuneration and of the conditions of employment and unless specifically excluded, they may become the subject of bargaining" in those states which "have recognized the right of public employees to collective bargaining." *Id.* at 251, 353. See also T. BLEAKNEY, *RETIREMENT SYSTEMS FOR PUBLIC EMPLOYEES* 160-61 (1972).

8. HOUSE COMM. ON EDUCATION AND LABOR, 95TH CONG. 2D SESS., *PENSION TASK FORCE REPORT ON PUBLIC EMPLOYEE RETIREMENT SYSTEMS* 145 (Comm. Print 1978) [hereinafter cited as *PENSION TASK FORCE REPORT*].

sion plans.<sup>9</sup> First, advance funding helps insure the availability of a source of money to meet pension claims as they become due. Second, the investment income earned on fund assets reduces the ultimate cost to taxpayers who must finance pension claims. As the author of a major study of public pension funds explains:

A pension fund represents one of the few means by which a state or local government can realize investment yield, which is a painless source of income to meet pension disbursements. That income will serve to reduce the upward pressure on future tax rates. Moreover, the investment yield of a public pension fund is held in trust for the pension plan; it therefore offsets costs, not for government in general, but specifically with respect to the pension plan. Holding that particular cost in check helps to assure continuation of the commitment.<sup>10</sup>

The objective of public pension fund regulation, therefore, should be the accumulation of a fund sufficient to provide public employees the promised benefits at the least cost to taxpayers. To accomplish this objective, the regulatory legal framework must seek, within an appropriate risk level, the maximization of return on investments in order that the fund might realize the financial purposes of the pension system. Portfolio selection efficiency,<sup>11</sup> in other words, should be the principal, if not the sole, objective of pension fund regulation.

## B. SOCIAL WELFARE IMPROVEMENT

### 1. Definitions

Some commentators argue that pension fund regulation should seek social welfare improvements through fund investments which, for example, create employment opportunities, increase housing, or further environmental protection.<sup>12</sup> Before discussing the viability of social welfare improvement as a con-

9. See PENSION TASK FORCE REPORT, *supra* note 8, at 146; T. BLEAKNEY, *supra* note 7, at 113-17; R. TILOVE, *supra* note 6, at 139-40.

10. R. TILOVE, *supra* note 6, at 140.

11. "An efficient portfolio is one that is fully diversified. For any given rate of return, no other portfolio has less risk, and for a given level of risk, no other portfolio provides superior returns." J. LORIE & M. HAMILTON, *THE STOCK MARKET: THEORIES AND EVIDENCE* 270 (1973).

12. See, e.g., J. RIFKIN & R. BARBER, *THE NORTH WILL RISE AGAIN: PENSION POLITICS AND POWER IN THE 1980s* (1978); Ferguson, *Social Investing: An Advocate's Perspective*, in *SHOULD PENSION ASSETS BE MANAGED FOR SOCIAL/POLITICAL PURPOSES?* AN EBRI POLICY FORUM 93 (D. Salisbury ed. 1980); Leibig, "You Can't Do That With My Money"—A Search for Mandatory Social Responsibility in Pension Investments, 6 J. OF PENS. PLANNING AND COMPLIANCE 358 (1980); Ravikoff and Curzan, *Social Responsibility in Investment Policy and the Prudent Man Rule*, 68 CALIF. L. REV. 518 (1980). See also *Pension Funds Investments Outside New York Debated*, N.Y. Times, Feb. 8, 1982, at B-2, col. 1.

trol objective of pension fund regulation, it is important first to define the meaning of social welfare improvement in this context.

As economists use the term, a social welfare improvement is the creation of a private gain without any accompanying private loss.<sup>13</sup> Thus, in economic terms, a social welfare improvement through the investment of plan assets in home mortgages to increase housing occurs only if plan participants or the plan sponsor are not worse off as a result of the investment. In other words, if the investment produces more housing and at the same time maximizes value for the plan participants and sponsor within an established level of risk, the investment will have caused a social welfare improvement. On the other hand, if such an investment subjects the fund to a higher level of risk or results in a smaller expected return than the maximum expected return available for the fund's established risk level, no social welfare improvement will occur. Despite the housing gain, the plan participants and sponsor are worse off as a result of the investment.

An investment that results in a social welfare improvement in the economic sense is consistent with portfolio selection efficiency under two circumstances. First, if two investments, *A* and *B*, have the same financial characteristics,<sup>14</sup> and investment *A* also benefits some individuals or groups not covered by the plan, an investment in *A* produces social welfare improvement in the economic sense since plan participants will receive no less with investment *A*, nor incur any greater risk, than they would with investment *B*.<sup>15</sup> These investments are referred to as financially comparable investments. Second, if investment *A* benefits nonplan participants but has poorer financial characteristics than investment *B*, and if investment *A* benefits plan participants indirectly as members of a larger group to an extent at least equal to the greater financial return, or the

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13. See J. HIRSHLEIFER, *PRICE THEORY AND APPLICATIONS* 521-24 (2d ed. 1980); P. LAYARD & A. WALTERS, *MICROECONOMIC THEORY* 30 (1978).

14. The term "financial characteristics" refers to the risk, return and liquidity traits of an investment and its effect on a fund's diversification.

15. This is called by some the "all-things-being-equal" or "comparability" criterion. See, e.g., SHOULD PENSION ASSETS BE MANAGED FOR SOCIAL/POLITICAL PURPOSES? AN EBRI POLICY FORUM 6, 23, 348, 356 (D. Salisbury ed. 1980) [hereinafter cited as EBRI POLICY FORUM]; Hutchinson & Cole, *Legal Standards Governing Investment of Pension Assets for Social and Political Goals*, 128 U. PENN. L. REV. 1340, 1367 (1980). The all-things-being-equal criterion is also referred to as socially sensitive investing, *id.* at 1345, and as XX investing, Schotland, *Should Pension Funds be Used to Achieve "Social" Goals?* (pt. 1), 119 Tr. & Est. 10 (Sept. 1980).

lesser risk, offered by investment *B*,<sup>16</sup> investment in *A* produces a social welfare improvement. Such an investment is called a collateral return investment.

Some advocates of social investing use the term "social welfare" in a broader, noneconomic sense, however. These advocates argue that investments which produce certain gains for nonplan participants should be made despite an accompanying loss to plan participants. Under this view, socially responsible investments are those "which either (1) permit the sacrifice of safety, return, diversification, or marketability; or (2) are undertaken to serve some objective that cannot be related to the interests of plan participants and beneficiaries in that capacity as such."<sup>17</sup> According to this definition of social welfare improvement, the question of social desirability does not arise when the relative return and risk factors of two potential investments are equal.<sup>18</sup> Rather, the gain of one person or group that is considered to outweigh an accompanying loss to others is a social welfare improvement.<sup>19</sup> In the noneconomic sense,

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16. This is referred to as the collateral benefit criterion. See, e.g., Carter, *The Issue of National Policy*, in *SHOULD PENSION ASSETS BE MANAGED FOR SOCIAL/POLITICAL PURPOSES?* AN EBRI POLICY FORUM 19, 23 (D. Salisbury ed. 1980); Ferguson, *supra* note 12, at 99; Hutchinson & Cole, *supra* note 15, at 1368; Langbein & Posner, *Social Investing and the Law of Trusts*, 79 MICH. L. REV. 72, 94 (1980).

17. Hutchinson & Cole, *supra* note 15, at 1346. In his introduction to the EBRI forum papers on social investing, Salisbury explains noneconomic social welfare as follows:

The strongest advocates of social investing argue that economic return should be secondary to achieving "social" results ("political," "socially dictated," or "divergent"). This view is set forth forcefully by Barber and Rifkin, and it is this view that has elicited the strongest response. Consistent with this approach, an interesting classification system has been set forth by Marc Gertner to aid in discussing arguments for accepting economic loss in order to achieve social/political benefits. He described socially responsible investments "as those investments which: (1) carry a lesser rate of return and/or (2) have a lower credit rating and quality and/or (3) have less liquidity or marketability than other forms of investment or specific investments readily available in the marketplace, but which will: (1) create employment opportunities for plan participants and/or (2) have a greater social or moral quality."

Salisbury, *An Overview*, in *SHOULD PENSION ASSETS BE MANAGED FOR SOCIAL/POLITICAL PURPOSES?* AN EBRI POLICY FORUM 6 (D. Salisbury ed. 1980). Investments in pursuit of social welfare improvement in a noneconomic sense are referred to as socially dictated investments, Hutchinson & Cole, *supra* note 15, at 1346, and as divergent or alternative investments, Schotland, *supra* note 15, at 10.

18. See Salisbury, *supra* note 17, at 6.

19. See, e.g., N. HAMILTON & P. HAMILTON, *GOVERNANCE OF PUBLIC ENTERPRISE* 50 (1981); P. LAYARD & A. WALTERS, *supra* note 13, at 30-31. See *infra* text accompanying note 50.



therefore, social welfare improvement is fundamentally inconsistent with the principal objective of pension fund regulation—portfolio selection efficiency.

## 2. *Economic Social Welfare Improvement*

### a. Financially Comparable Investments

If two investments are financially comparable, there can be no objection on economic grounds to the selection of the investment that produces utility<sup>20</sup> gains for nonplan participants, since there is no loss to plan participants or the plan sponsor. Some states have adopted social welfare improvement through financially comparable investments<sup>21</sup> as an objective for public pension fund management through statutory provisions requiring preference to be given local investments, "all other things being equal."<sup>22</sup> As one commentator notes, however, such "social" investing "is so obviously desirable that it must suffer some flaw or it would sweep the field on its own."<sup>23</sup> One obvious flaw is that there are not enough financially comparable social investment opportunities to enable pension funds to pursue social welfare improvement effectively.<sup>24</sup> As a result of a limited market, the pursuit of social goals through plan fund investments is likely to increase the fund's level of risk or reduce the fund's level of expected return in contravention of portfolio selection efficiency. A pension fund consistently managed in pursuit of social goals is likely to be less diversified

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20. Utility is a term used by economists to refer to an individual's well-being or happiness. The authors of one economic text book explain that an individual "has a happiness, or *utility*, function  $u$  that tells us how well off he is. . . ." P. LAYARD & A. WALTERS, *supra* note 13, at 5. Utility is technically defined as "the variance whose relative magnitude indicates direction of preference: In finding the most preferred position, the individual maximizes utility." J. HIRSCHLEIFER, *supra* note 13, at 66.

21. See *supra* text accompanying notes 14-15.

22. Schotland, *Should Pension Funds be Used to Achieve "Social" Goals?* (pt. 2), 119 Tr. & Est. 27, 28 (Oct. 1980). In an attempt to expand the investment authority of the five state retirement systems and orient their investment policies toward enhancing the general welfare of the state and its citizens the Ohio legislature recently added the following to its statute:

In exercising its fiduciary responsibility with respect to the investment of such funds, it shall be the intent of the board to give consideration to investments that enhance the general welfare of the state and its citizens where such investments offer quality return and safety comparable to other investments currently available to the board. The board shall adopt in regular meeting, policies, objectives or criteria for the operation of the investment program.

OHIO REV. CODE ANN. § 3309.15 (Page Supp. 1981).

23. Schotland, *supra* note 22, at 28.

24. *Id.* See also EBRI POLICY FORUM, *supra* note 15, at 348.

than a fund managed solely for the wealth maximization of the fund's beneficiaries. Underdiversification results from sampling error created by the limited number of potential investments and sampling bias caused by financially comparable social investing criteria that exclude a disproportionate number of investments in large firms concentrated in particular regions and industries.<sup>25</sup> Underdiversification subjects a fund to firm specific risks that adequate diversification would eliminate.<sup>26</sup>

The limited number of potential investments that satisfy the financially comparable social investing criteria could also adversely affect fund return. High demand for limited investment opportunities can raise the price of such stock above the price it would command if investors considered only the financial characteristics of the stock issuer. Investment in overvalued stock means a lower return for the fund than it could achieve through investment in properly priced stocks with the same risk characteristics. High demand and consequent lower return are particularly likely if managers of large funds seek investments in local firms or venture capital firms as part of a social investment program.

Even when social investment opportunities exist in a market characterized by enough buyers, stocks, and transactions that stock valuation is based on financial considerations, social investing can affect fund return. A fund management governed by social considerations is likely to generate higher research and transaction costs because of a need to anticipate and respond to changing corporate policies and changing perceptions of social welfare. These additional costs translate into a lower net return for funds seeking social welfare maximization than for funds seeking only portfolio selection efficiency.<sup>27</sup>

In addition to potential fund underdiversification and its attendant economic loss to plan participants, the pursuit of social welfare improvements through financially comparable investments raises serious trust law issues with respect to the fiduciary's duty to manage trust funds for the exclusive benefit of the trust's beneficiaries.<sup>28</sup> At the very least, this duty mandates in-

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25. Langbein & Posner, *supra* note 16, at 85.

26. Firm specific or nonmarket risk is the risk attributable to the particular business situation of a firm and is contrasted with systematic or market risk which is the risk attributable to the industry or economy as a whole. The former is diversifiable, that is, it can be eliminated through an adequate mix of securities in a portfolio. See generally J. LORIE & M. HAMILTON, *supra* note 11, at 275, 276; Langbein & Posner, *supra* note 16, at 79.

27. Langbein & Posner, *supra* note 16, at 93.

28. "The trustee is under a duty to the beneficiary to administer the trust

vestments that are primarily for the benefit of trust beneficiaries.<sup>29</sup> Even under such an interpretation of the exclusive benefit rule, investments that produce incidental benefits to a third party arguably are permissible only if such investments maximize the fund's return within a given risk level, the fiduciary acts without any trace of self-interest, and the investments produce an additional benefit for plan participants as members of a larger group.<sup>30</sup>

Finally, implementing the social welfare improvement objective through financially comparable investments raises several major problems. Among these are problems in defining social goals, creating a system of distinctive weights to make

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solely in the interest of the beneficiary." RESTATEMENT (SECOND) OF TRUSTS § 170(1) (1959). Comment q to § 170(1) provides:

Action in the interest of a third person. The trustee is under a duty to the beneficiary in administering the trust not to be guided by the interest of any third person. Thus, it is improper for the trustee to sell trust property to a third person for the purpose of benefiting the third person rather than the trust estate.

*Id.* comment q. For a discussion of the various trust law issues raised by social investing, see PENSION TASK FORCE REPORT, *supra* note 8, at 192-94; Hutchinson & Cole, *supra* note 15, at 1359.

29. For example, the trustees of the United Mine Workers pension fund invested significant fund assets in certain electric utility companies to assist the union in its efforts to buy control of the utilities and force them to burn union-mined coal. Although the investments may have benefited plan beneficiaries, since fund receipts were directly related to the tonnage of union-mined coal, the court found that the investments were made "primarily for the collateral benefit they gave the union." The investments thus "present a clear case of self-dealing on the part of the trustees, . . . and constituted a breach of trust." *Blankenship v. Boyle*, 329 F. Supp. 1089, 1106 (D.D.C. 1971), *aff'd*, 511 F.2d 447 (D.C. Cir. 1975). In *Withers v. Teachers' Retirement Sys. of New York*, 447 F. Supp. 1248 (S.D.N.Y. 1978), *aff'd*, 595 F.2d 1210 (2d Cir. 1979), the purchase of city bonds as part of a financial plan to stave off the city's potential bankruptcy was found to be prudent. The court stated:

[N]either the protection of the jobs of the City's teachers nor the general public welfare were factors which motivated the trustees in their investment decision. The extension of aid to the City was simply a means—the only means, in their assessment—to the legitimate end of preventing the exhaustion of the assets of the TRS in the interest of all of the beneficiaries. Notably, the importance of the solvency of the City to the TRS lay not only in its role as the major contributor of funds but also as the ultimate guarantor of the payment of pension benefits to participants in the TRS . . . .

*Id.* at 126. In their discussion of the exclusive-benefit test, two commentators pointed out:

Although the exclusive-benefit rule of the Internal Revenue Code obviously applies to the investment of plan assets, historically it has not been a stringent constraint. . . . The Internal Revenue Service has interpreted the exclusive-benefit rule to permit some collateral benefit to other persons, so long as the investments have the primary purpose of benefiting employees or their beneficiaries.

Hutchinson & Cole, *supra* note 15, at 1348.

30. Hutchinson & Cole, *supra* note 15, at 1367.

the pursuit of inconsistent social goals operational, collecting and using data needed to identify investments that satisfy established financial and social criteria, and evaluating the performance of those charged with all these tasks. The nature and effect of such implementation problems are explored later in this part.<sup>31</sup> At this point, it suffices to say that the severity of these problems raises serious questions regarding the desirability and feasibility of social welfare improvement, no matter how defined, as a control objective of pension fund regulation.

#### b. Collateral Return Investments

Investments that produce utility gains for nonplan participants but sacrifice fund return or risk levels theoretically can comply with portfolio selection criteria if they produce nonfinancial returns for plan participants as members of a larger group benefited by the investments. As long as the present value of the collateral benefit of an investment to plan participants equals or exceeds the present value forgone by not investing in another investment with a higher expected financial return, the same risk level and no collateral benefit to plan participants, investment in the former is at least theoretically consistent with portfolio selection efficiency.<sup>32</sup>

Investing in local firms, for example, strengthens the local economy, results in a larger and stronger tax base, and enables local government to maintain or increase city services, create new jobs, and postpone tax rate increases. Plan participants share in these benefits as residents and taxpayers. Another commonly cited example of a collateral benefit is employment security. Thus, employees faced with losing their jobs because of a factory closing might induce their employer to stay by loaning plan funds to the employer at more favorable terms than are otherwise available.<sup>33</sup> The increased risk to the plan fund arguably is offset by greater employment security. Still

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31. See *infra* notes 39-49 and accompanying text.

32. It is important to note that portfolio selection efficiency through collateral as well as financial return is meaningful in the context of defined benefit plans only if all parties involved in such plans understand that the promised benefits expressed in terms of dollars mean a defined dollar amount less collateral returns which have been, are currently being, or will be received by plan participants. Otherwise, the application of the collateral benefit theory to defined benefit plans increases the employer's costs and liabilities to the extent that financial returns are foregone for collateral returns. Furthermore, to the extent that the plan sponsor cannot or will not meet such increased costs and satisfy its increased liabilities, employees lose at least a portion of their expected retirement income.

33. Langbein & Posner, *supra* note 16, at 90.

another example of benefits collateral to an investment's financial return is the emotional or psychological satisfaction plan participants derive from the knowledge that pension funds are being invested in socially beneficial projects like low-income housing for the poor.<sup>34</sup>

Nonetheless, the collateral benefit justification for social welfare maximization through pension funds has obvious problems. The fund manager, for example, must determine what collateral benefits derive from various investments and trace these benefits to individual plan participants of the particular pension fund. In addition, the fund manager needs a system for quantifying collateral benefits, determining the values each plan participant places on the collateral benefits, and reconciling the differences among values.<sup>35</sup> These determinations, assuming they can be made, must be constantly reviewed and modified to comport with the changing needs and values of plan participants. As discussed in the next section of this part, costs attendant to making, reviewing, and modifying these determinations render social welfare maximization through fund management administratively infeasible.

In addition, the collateral benefits received through social investments may not be consistent with the interests of all plan participants. For example, local investments could, in fact, create or strengthen firms that are competitors of firms employing plan participants. One result of such investing could be a loss of jobs for current employees. Investing in the plan participants' employer might create a collateral benefit of greater employment security for workers, but produce no benefit for retirees.<sup>36</sup> In fact, if such investments increase fund risk or reduce the solvency of the fund assets, retirees could receive smaller retirement benefit checks or, even worse, no checks at all. Even if social investments produce collateral benefits, such benefits will be diluted, since plan participants receive only a

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34. See generally J. HIRSHLEIFER, *supra* note 13, at 84. Langbein and Posner refer to such emotional or psychological satisfaction as consumption value as distinguished from investment value. Langbein & Posner, *supra* note 16, at 94. They point out that "it is strongly implied by economic theory, that people who choose to invest in mutual funds dedicated to social investing derive a consumption value from their investment, since the pure investment value is, at least on an expected basis, inferior to that of alternative investment vehicles." *Id.*

35. See Langbein & Posner, *supra* note 16, at 95; Salisbury, *supra* note 17, at 12.

36. See Langbein & Posner, *supra* note 16, at 90. See also EBRI POLICY FORUM, *supra* note 15, at 12, 24.

fraction of the benefit produced for a larger group. Thus, absent a unique set of circumstances, it is unlikely that social investment gains in the form of collateral benefits to plan participants will in fact offset losses in foregone financial returns.

Finally, a strong public policy argument can be made that workers should not be able to trade a portion of their future retirement income for present collateral returns. Substituting collateral benefits for a portion of financial return may leave plan participants without enough retirement income in later years to meet minimum subsistence levels, forcing some of them to turn to public welfare for support. To protect society's resources from such additional burdens, retirement plans should focus exclusively on supplying retirees with retirement income, rather than on generating diluted, nonfinancial collateral benefits.<sup>37</sup>

### 3. *Noneconomic Social Welfare Improvement*

Social welfare improvement in the noneconomic sense may be illustrated by the home mortgage investment hypothetical used earlier. If home mortgage investments aimed at increasing housing opportunities for the community subject the pension fund to a higher level of risk or result in a smaller expected return than the maximum expected return available for the fund's established risk level, plan participants and the plan sponsor will incur a loss.<sup>38</sup> Notwithstanding the loss to plan participants, the housing gain to others constitutes a so-

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37. The same rationale is used in part to justify state blue sky laws. For example, a well-informed individual who fully understands the nature of high risk securities may still desire to invest in such securities in the hope of realizing high returns. Investment losses from such high risk securities may put such an individual's financial status below the minimum welfare sustenance level, however. Since such a person would pose an additional burden to society's welfare programs, the prohibition of the sale of certain high risk securities may be appropriate to achieve the legitimate goal of preventing such a potentially harmful investment. See R. Coffey, *Securities Regulation Policy and Analysis*, 581 f (1978) (unpublished multilith, available at Case W. Res. Univ. School of Law).

After proposing a "social option fund" for defined contribution plans into which an employee could elect to have contributions made for his or her account, Langbein and Posner note that "those who believe that it is sound social policy to discourage individuals from trading future retirement benefits for current consumption will have a ground for continuing to oppose social investing even in the voluntaristic mode that we have endorsed." Langbein & Posner, *supra* note 16, at 107.

38. See *infra* text accompanying note 50. During the hearings of the President's Commission on Pension Policy one speaker noted that an involuntary wealth redistribution can occur between investors excluded from a segment of

cial welfare improvement only if that term is defined in a noneconomic sense. Noneconomic social welfare improvement is the involuntary redistribution of wealth on the basis of a collective judgment that the gain to one person or group outweighs the accompanying loss to another.

The pursuit of social welfare improvement in this broader, noneconomic sense requires pension fund managers to identify the goals that individual members of society regard as desirable.<sup>39</sup> After identifying social goals, fund managers must measure and balance the private gains and losses associated with pursuing a number of competing goals and set priorities to determine which goals to seek through pension fund management.<sup>40</sup> To establish priorities among competing goals, plan management must have a set of explicit weights to attach to the welfare levels of different groups in society. Economists are not yet able, and it is difficult to imagine elected executives or legislatures being able, to give regulators such a set of distributive weights to apply mechanically in the decisionmaking process of investing pension funds.<sup>41</sup> Thus, regulators are left to create their own system of weights.<sup>42</sup>

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the capital market due to social welfare improvement criteria and investors not so excluded. The speaker stated:

If you constrain the flow of funds in any mandatory way, what happens is that money will still flow there from people who are not constrained and they will get windfall profits because others are constrained from playing in that area. So when you set up these mandatory barriers to funds flowing in certain directions, what happens is it creates windfall profits for those who can avoid those barriers and it does constitute somewhat of a tax on the people who are prohibited from investing in certain areas. The tax really amounts to a wealth transfer between the two kinds of investors.

EBRI POLICY FORUM, *supra* note 15, at 354.

39. Professor Schotland lists this requirement as the first of seven acute problems in implementing social welfare improvement as a control objective of pension fund investment activity:

*Problem One.* Which divergent goals shall be pursued? Consider: equal employment opportunity in terms of race, sex, age, et al.; occupational safety and health; consumer protection; unionization; environmental protection; energy conservation; discouraging involvement in countries violating human rights; inner-city redevelopment; housing; small business; local or regional development.

Schotland, *supra* note 22, at 30.

40. It should be noted that the establishment of priorities to rank multiple social goals "is not merely a matter of the finitude of resources . . . [W]hat happens if a pension system decides it wants both to promote equal employment opportunity and to discourage involvement in South Africa, and finds that a firm at the forefront of equal employment opportunity also is involved in South Africa?" *Id.*

41. See R. SCHMALENSSEE, *THE CONTROL OF NATURAL MONOPOLIES* 20-21 (1979).

42. *Id.* at 21.

To identify social goals and devise a system of distributive weights that reflects society's values, regulators need to know the interests of all potential utility gainers and losers associated with implementing any wealth redistribution scheme under consideration.<sup>43</sup> Then, they must evaluate the arguments of the affected parties in the context of a vast amount of information in such varied disciplines as economics, ethics, sociology, psychology, and political science. Finally, the regulators need to disseminate their findings and decisions to society with the ability to respond quickly to changes in societal views.<sup>44</sup>

There are significant problems in assigning such tasks to pension plan regulators. First, the needed information, even if obtained,<sup>45</sup> may well be nonfunctional because of its quantity, variety, and complexity.<sup>46</sup> Second, the cost of performing these tasks is likely to be prohibitive. Furthermore, given the nature of the tasks involved in formulating and implementing social policy, regulators must have broad discretionary authority, which increases the opportunity for special interest dominance and arbitrary action or inaction by regulators.<sup>47</sup>

Social welfare improvement issues are more appropriately decided by the political process than by a bureaucratic admin-

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43. "[T]he problem of setting natural monopoly prices so as to take account of the differential effects of price changes on different groups in the economy" offers a useful analogy since "[i]t requires the ability to evaluate the ultimate incidence on various groups of consumers of prices charged business." *Id.* at 20-21.

44. That such changes occur is obvious from the fact that "there are [social] goals that evidently don't interest today's advocates of divergent investing, such as discouraging production of alcohol and tobacco and war material. [The latter] goal, which stirred such activity against Dow Chemical only a few years ago, seems forgotten." Schotland, *supra* note 22, at 30.

45. The problem of obtaining all the necessary information relevant to social policy decisions should not be underestimated. For example:

The lack of information on which to base investment decisions aimed at furthering divergent goals is severe. The fact that "[t]here is no systematic method for obtaining and evaluating information about the activities and practices of companies in which the funds invest" is deemed the first of three respects in which "the current decisionmaking framework appears inadequate" from the perspective of one of the best studies advocating alternative investing.

Schotland, *supra* note 22, at 31-32. Furthermore, even if one can obtain such data as GE's relations with the EEOC, or GM's with OSHA, one cannot "make a decision about whether GE or GM is notably good, or notably bad without having data on comparable firms." *Id.* at 32.

46. See generally Coffey, Book Review, 124 U. PA. L. REV. 268, 278-79 (1975).

47. R. SCHMALENSEE, *supra* note 41, at 17; Schotland, *supra* note 22, at 36.



istrator.<sup>48</sup> A broad based body of elected representatives is a more likely forum for the systematic presentation and consideration of the needs and preferences of individuals and groups within society. Furthermore, the political process is better equipped to coordinate decisions about various social policies.<sup>49</sup> Defining and implementing social policy in light of competing societal needs and interests is the business of elected representatives. In contrast, social policy decisions are unrelated to the pension fund manager's task of providing plan participants with promised benefits from available fund assets.

Finally, a collective decision to pursue a particular scheme of wealth redistribution should be made and implemented directly and openly. Using pension funds to further noneconomic social welfare improvements constitutes a hidden subsidization by plan participants and taxpayers of other segments of society.<sup>50</sup> For example, social investing may require taxpayers and plan participants to increase their contributions to enable a pension fund to promote housing opportunities through mortgage or construction industry investments that reduce the fund's return. It may also cause plan participants to forego benefit increases because of decreased financial return on fund assets. The process of redistributing wealth through indirect subsidization impedes responsible review of the individuals who are deciding the relative merits of individual utility gains and losses on behalf of society.<sup>51</sup> Significantly, to the extent that social welfare maximization through pension fund regulation creates hidden subsidization, it constitutes an "effort to take money from the elderly, who themselves need financial aid as much or more than any other group."<sup>52</sup>

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48. See generally R. SCHMALENSEE, *supra* note 41, at 14, 17, 21-22. See also Langbein & Posner, *supra* note 16, at 111-12.

49. See R. SCHMALENSEE, *supra* note 41, at 14, 21-22. Failure to coordinate policy decisions can result in what Professor Schotland calls "interference." That is, the impact of the social investing policies of a pension fund may be effectively negated by inconsistent state policies. For example, despite a fund loan to a firm aimed at attracting or keeping the firm, the adverse tax structure of the state may result in that firm locating elsewhere. In summary, without effective policy decision coordination, "[d]ivergent investors not only face insurmountable obstacles in deciding what to do, how to do it, and whether doing it will matter, but other parts of their own team may be running inconsistent plays." Schotland, *Should Pension Funds be Used to Achieve "Social" Goals?* (pt. 3), 119 Tr. & Est. 26, 27 (Nov. 1980).

50. See generally Posner, *Taxation by Regulation*, 2 BELL J. OF ECON. & MGMT. SCI. 22 (1971).

51. *Id.* at 43-44.

52. Schotland, *supra* note 22, at 28. It should be noted that use of public pension funds to effect such an involuntary wealth redistribution may consti-

Although other social goals may be as important as providing retirement income for workers, they should not be consciously pursued through pension fund regulation. Pension fund regulation can directly affect the availability of funds for providing retirement income for public employees. Tax incentives, such as tax abatement or industrial revenue bond programs, can have a more profound and direct effect on business development within a community than pension fund regulation.<sup>53</sup> Furthermore, those in charge of public pension funds should not have to decide conflicts among competing social goals or conflicts between portfolio selection efficiency and noneconomic social welfare improvements. To promote administrative efficiency, to avoid arbitrary actions by regulators and special interest group dominance over regulators, and to prevent hidden subsidizations of other groups in society by plan beneficiaries and taxpayers, social welfare improvement should be rejected as an objective of pension fund regulation.<sup>54</sup>

### III. REGULATORY LEGAL FRAMEWORK

#### A. BACKGROUND

Once the plan sponsor—in the case of public plans, the government—identifies the purpose of its retirement plan and the proper control objective of fund regulation, the next step is the development of a regulatory framework that will foster the objective chosen for the plan. The critical issue here is what matrix of laws, organizational structure, powers and duties, and motivating factors will encourage the parties involved in fund management to strive for and achieve portfolio efficiency.

There are essentially two structures for the control of public enterprises.<sup>55</sup> One is the government department form; the

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tute a taking of property without due process or an unconstitutional impairment of contractual obligations. See, e.g., PENSION TASK FORCE REPORT, *supra* note 8, at 7-13.

53. See EBRI POLICY FORUM, *supra* note 15, at 355; R. SCHMALENSEE, *supra* note 41, at 19; Schotland, *supra* note 49, at 29-30. See also Posner, *supra* note 50, at 47.

54. Similarly, scholars have argued that economic efficiency should be the sole objective of antitrust policy, R. BORK, THE ANTITRUST PARADOX: A POLICY AT WAR WITH ITSELF (1978); R. POSNER, ANTITRUST LAW: AN ECONOMIC PERSPECTIVE (1976), the control of natural monopoly, R. SCHMALENSEE, *supra* note 41, and the regulation of mass transit, N. HAMILTON & P. HAMILTON, *supra* note 19.

55. The company form, whereby a government firm registers as a limited liability company under private corporation laws, has no real relevance for a government entity operating a public employee retirement system. For a discussion of the company form uses, see United Nations Technical Assistance Administration, Some Problems in the Organization and Administration of

other is the public corporation form. Generally speaking, the government department form is characterized as follows:

[D]irect responsibility on all matters devolves on the director of the department and ultimately on the chief executive of the government. Direct government control of operations is exercised by executive order and legislative review. Personnel are usually subject to civil service regulation. The enterprise is financed by annual appropriations and is subject to the budget, accounting, and audit controls applicable to other government activities. The enterprise frequently possesses the sovereign immunity of the state.<sup>56</sup>

The second public enterprise structure, the public corporation form,<sup>57</sup> although encompassing many variations, is generally characterized by its own board of directors, financing, budget, accounting and auditing procedures, as well as the capacity to sue and be sued in its own name. The public corporation, however, is created by the legislature and is subject to government control as provided in the enabling statute.

Both the department and public corporation forms have widely recognized deficiencies. The major problems in department form enterprises are informational poverty, response lag, and a high degree of operating inflexibility due to strong pressures to conform to standard government regulations and procedures.<sup>58</sup> Operating inflexibility leads to the informational poverty and response lag which ultimately translate into lost opportunities and higher costs. The public corporation overcomes the problems of the department form through its autonomy from the extent of government control inherent in the department form.<sup>59</sup> A major problem in the governance of public corporations exists, however, because "there is no consistent pattern or coherent theory addressing the issues of policy formation and efficient operation."<sup>60</sup> This problem is apparent in public employee retirement systems which are administered, with a few exceptions, by governing boards rather than government departments.<sup>61</sup> A unique aspect of public pension plans

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Public Enterprises in the Industrial Field at 12-15, U.N. Doc. ST/TAA/M/7 (1954) [hereinafter cited as United Nations Report].

56. N. HAMILTON & P. HAMILTON, *supra* note 19, at 72. See United Nations Report, *supra* note 55, at 5-9.

57. For detailed discussions of the public corporation form, see United Nations Report, *supra* note 55, at 9-11; N. HAMILTON & P. HAMILTON, *supra* note 19, at 72, 75-84.

58. See United Nations Report, *supra* note 55, at 6-8; N. HAMILTON & P. HAMILTON, *supra* note 19, at 73-75.

59. See *supra* text accompanying notes 56-57.

60. N. HAMILTON & P. HAMILTON, *supra* note 19, at 78.

61. PENSION TASK FORCE REPORT, *supra* note 8, at 65; T. BLEAKNEY, *supra* note 7, at 148.

is "the reluctance or inability of one legislature or administration to commit its successors to a particular policy or course of action. . . ."<sup>62</sup> Thus, many retirement systems lack any coherent policy framework.<sup>63</sup> Furthermore, the political arena in which public plans exist has resulted in the ad hoc development of public pension systems through a complex and confusing patchwork of laws and programs.<sup>64</sup> Not surprisingly, the nature and extent of the board's duties, which "range from making fundamental policy decisions to handling minute administrative details," depend on "the traditional and political environment in which the system operates" in addition to the system's size and staff.<sup>65</sup> The lack of a clearly developed process with well defined lines of authority for policymaking has produced a plethora of administrative inefficiencies culminating in inequitable benefit structures, escalating costs, and financial instability.<sup>66</sup>

The following section analyzes the existing structure and process used in the governance of the Minnesota State Board of Investment and the Ohio School Employees Retirement System.<sup>67</sup> It identifies the problems in these and other systems and establishes the need for a modified regulatory framework designed to further the control objective of portfolio efficiency.

## B. EXISTING FRAMEWORK

### 1. Governance Structure

As with most public employee retirement systems, the Ohio School Employees Retirement System (SERS) vests the general administration and management of the system in a retirement board.<sup>68</sup> The board consists of two ex officio members, the state auditor and the attorney general, and three elected participants.<sup>69</sup> The board hires an executive director,<sup>70</sup>

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62. PENSION TASK FORCE REPORT, *supra* note 8, at 63.

63. *Id.*

64. *Id.*

65. T. BLEAKNEY, *supra* note 7, at 148-49.

66. PENSION TASK FORCE REPORT, *supra* note 8, at 80.

67. The findings are based on the author's case studies of these two systems involving a review of relevant statutes, system reports and publications, board resolutions, personal interviews with several individuals active in various aspects of the systems' operations, and independent studies on the subject. Observations of retirement systems in general are based on several major studies of public employee retirement systems. See, e.g., PENSION TASK FORCE REPORT, *supra* note 8; T. BLEAKNEY, *supra* note 7; R. TILOVE, *supra* note 6.

68. OHIO REV. CODE ANN. § 3309.04 (Page 1980).

69. OHIO REV. CODE ANN. § 3309.05 (Page 1980). The three elected members currently are the business manager of the Cleveland School Board, a

who falls within a newly enacted definition of fiduciary,<sup>71</sup> but who is given no specific statutory duties or powers.

Although Minnesota's retirement systems are run by retirement boards, the investment responsibility for the systems resides in the State Board of Investment (SBI). The SBI consists of five constitutional officers.<sup>72</sup> A statutorily created Investment Advisory Council (IAC) advises the SBI and the executive director on general investment policy.<sup>73</sup> The executive director is appointed by the SBI and is responsible for planning, directing, coordinating, and executing administrative and investment functions in conformity with the policies and directives of the SBI.<sup>74</sup> The executive director must be an experienced investment professional.<sup>75</sup>

The most obvious deficiency in the retirement board governance structure, even with the modifications that exist in the Minnesota system, is the lack of board knowledge or expertise in investment, banking, and finance.<sup>76</sup> Although the board can hire investment advisors<sup>77</sup> to aid it in fulfilling its investment responsibilities, the board bears ultimate responsibility for establishing investment policy, choosing an investment manager, communicating that policy and guidelines for its implementation to the investment manager, and measuring and reviewing the performance of its manager. At the very least, these tasks require a basic working knowledge of financial and investment

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school secretary, and a school bus driver who is a farmer, insurance salesman, and a member of the board of directors of a farm co-operative insurance program. Interview with Thomas R. Anderson, Executive Director, School Employees Retirement System of Ohio, in Columbus, Ohio (Aug. 5, 1981).

70. OHIO REV. CODE ANN. § 3309.11 (Page 1980).

71. OHIO REV. CODE ANN. § 3309.01 (Page Supp. 1981).

72. MINN. STAT. §§ 11A.03-.04 (1980).

73. MINN. STAT. § 11A.08 (1980) (amended 1981).

74. MINN. STAT. § 11A.07 (1980).

75. *Id.*

76. PEAT, MARWICK, MITCHELL & CO., MINNESOTA STATE BOARD OF INVESTMENT: PART II REPORT, VOL. 2: GOVERNANCE OF THE MINNESOTA STATE BOARD OF INVESTMENT 24, 27-28 (Aug. 1981) [hereinafter cited as PMM PART II REPORT]. "Less than 1 percent of all retirement system boards have members who are persons employed outside of government in fields related to the investment, banking, or finance field." PENSION TASK FORCE REPORT, *supra* note 8, at 67. This "absence of specialized investment boards no doubt generates certain deficiencies in asset management and investment." *Id.* at 189. For a discussion of the necessary areas of specialized technical expertise, see T. BLEAKNEY, *supra* note 7, at 151-55.

77. MINN. STAT. § 11A.04 (1980); OHIO REV. CODE ANN. § 3309.14 (Page 1980). "Increasingly, retirement boards have been turning to both in-house and outside professional advice and management in the management area." PENSION TASK FORCE REPORT, *supra* note 8, at 66.

concepts and theories. Even if the board uses advisors and the executive director to formulate and recommend policies and procedures, board members need sufficient knowledge to evaluate recommendations and to choose among alternative proposals. A lack of fundamental investment experience and knowledge can lead to one of two undesirable situations. First, the board may simply not perform the tasks of policy creation and communication, management oversight, and performance evaluation, resulting in inefficient portfolio management. Second, the executive director, board advisors, or government officials will perform these tasks in response to various interest groups. Portfolio management by these persons will relegate the board to the status of a rubber stamp for the acts of others over whom it has effectively lost control.<sup>78</sup> The inevitable result is conflicting policies and confusion over lines of authority, which translate again into inefficient portfolio management.<sup>79</sup>

Time demands placed on many board members, particularly government officials who serve as ex officio board members, exacerbate the problems created by the lack of requisite board expertise.<sup>80</sup> Because of the numerous and varied responsibilities of their government positions, government officials may lack the time and interest to devote to board duties.<sup>81</sup> In

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78. A recent study of Minnesota's State Board of Investment observed that "past and current practices tend to document the shift of authority from the SBI to either the Executive Director or the IAC." PEAT, MARWICK, MITCHELL & CO., MINNESOTA STATE BOARD OF INVESTMENT: PART I REPORT IV-4 (Apr. 1981) [hereinafter cited as PMM PART I REPORT]. For example, "until 1978, interpretation of the statutory limitations into informal investment policies was left to the Executive Director." PMM PART II REPORT, *supra* note 76, at 10. Similarly, a commentary on the regulation of mass transit concluded that "the [transit] boards in many of the case studies are only titularly carrying out their policymaking and monitoring functions. . . . [I]t is actually transit management who designs the policies, and the policies are rubberstamped by the board with minor or no alterations." N. HAMILTON & P. HAMILTON, *supra* note 19, at 27.

79. The Peat, Marwick, and Mitchell Report warns that the development within Minnesota of the "exercise of authority by a sub-set of those making up the governance body . . . can lead to a breakdown in the deliberative process, ineffective direction and control, confusion as to the real seat of authority and misunderstandings." PMM PART I REPORT, *supra* note 78, at IV-4.

80. "In the vast majority of cases, government officials achieve board membership on an ex officio basis. Only in a small percentage of plans are they elected by plan members." PENSION TASK FORCE REPORT, *supra* note 8, at 67.

81. See T. BLEAKNEY, *supra* note 7, at 149. Although the Peat, Marwick and Mitchell Report supports the board membership of state constitutional officers as elected representatives of taxpayers who bear the ultimate liability for pension payments, it notes that "it must be recognized . . . that these officials have multiple responsibilities to perform in state government, and that each officer's role as fiduciary for the investment process is only one of many other functions that he or she must fulfill." PMM PART II REPORT, *supra* note 76, at 27.

Ohio, for example, until the present attorney general made changes, there was little continuity in the attorney general's representative at SERS board meetings.<sup>82</sup> In Minnesota, most of the SBI's members do not even send representatives regularly to the IAC meetings.<sup>83</sup> A lack of commitment by board members because of other demands on their time or interests leads to the same problems created by lack of knowledge and expertise in fields essential to the efficient management of fund assets.

Finally, another impediment to efficient portfolio management in many public retirement systems is the politicization of the governance structure.<sup>84</sup> Because board members are often government officials whose election to state office is often wholly unrelated to board policies, the board may have members who are not particularly interested in board affairs.<sup>85</sup> In addition, the board may be deprived of a knowledgeable, committed member because his or her continued membership is dependent upon reelection to state office rather than upon his or her contribution to the board. Furthermore, the political nature of government office subjects *ex officio* board members to pressure from various interest groups that could affect their views and positions with respect to fund investments. For example, a policy of favoring instate investments or excluding investments in nonunion companies may attract needed political support for reelection to state office, but it may have a deleterious effect on efficient fund management.

## 2. Governance Process

In theory, a board having general responsibility for the retirement system is to establish the policy of the pension pro-

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82. Interview with Thomas R. Anderson, *supra* note 69.

83. Interview with Lawrence A. Martin, Executive Secretary, Legislative Commission on Pensions and Retirement, in St. Paul, Minn. (Aug. 11, 1981).

84. In Minnesota, for example, "[t]here has been a trend toward increasing politicization of the SBI." PMM PART I REPORT, *supra* note 78, at 4. This report attributes much of the controversy surrounding the SBI to the "change from an Executive Director who was more effective in dealing with political issues to one whose skills lie more in the investment area." *Id.* at 5. To a great extent, the role of the executive director in many systems is political since "[t]he time and attention of the plan administrator is demanded by legislative bodies, elected officials, various boards and commissions, employee representatives, and other special interests." PENSION TASK FORCE REPORT, *supra* note 8, at 68. See also T. BLEAKNEY, *supra* note 7, at 150-51, for a discussion of the political nature of the executive director's job. In Ohio the executive director acts as the liaison between the board and the legislature. Interview with Thomas R. Anderson, *supra* note 69.

85. See *supra* note 76.

gram and oversee the executive director's daily management of the system.<sup>86</sup> Based on the Minnesota experience, however, practice does not always reflect theory.<sup>87</sup> The reaction of those familiar with the SBI is that it has made little effort to formulate policy and provide direction for its staff.<sup>88</sup> The result has been that the executive director has controlled investment practices without formal board monitoring of investment results.<sup>89</sup> The IAC, which was established to assist the SBI in investment policy, has been underutilized by the SBI and has worked more closely with the executive director than the

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86. A relatively new Minnesota statute expressly sets forth such a governance process by requiring the SBI to "[f]ormulate policies and procedures deemed necessary and appropriate to carry out its functions" and to "[e]stablish a formula or formulas to measure management performance and return on investment." MINN. STAT. § 11A.04 (1980). The SBI also must hire an executive director who is "well qualified by training to administer and invest the money available for investment and possess experience in the management of institutional investment portfolios." MINN. STAT. § 11A.07 (1980). In contrast, the Ohio statute sets no specific qualification requirements for the executive director. The Minnesota executive director in turn must "[p]lan, direct, coordinate and execute administrative and investment functions in conformity with the policies and directives of the state board." MINN. STAT. § 11A.07 (1980). Although not as detailed, the Ohio statute authorizes the SERS board to "adopt rules and . . . authorize its administrative officers, or committees . . . to act for the board in accord with such policies. . . ." OHIO REV. CODE ANN. § 3309.04 (Page 1980). A newly enacted amendment directs the board to "adopt . . . policies, objectives or criteria for the operation of the investment program." OHIO REV. CODE ANN. § 3309.15 (Page Supp. 1981).

87. "While the policy roles of each of these three entities [SBI, IAC, and Executive Director] are defined in the statutes, the actual policy-making practice, as it has evolved over a number of years, is at some variance with the statutory description." PMM PART I REPORT, *supra* note 78, at I-2. *Accord* Interview with Lawrence A. Martin, *supra* note 83. *See also infra* note 175.

88. For example, when the present Minnesota state auditor became a member of the SBI, he found it "essentially lacking in goals and objectives." Interview with Arne H. Carlson, State Auditor, in St. Paul, Minn. (Aug. 13, 1981). The Peat, Marwick, and Mitchell study made similar observations, concluding that "the absence of formal policies left the SBI staff with no direction." PMM PART I REPORT, *supra* note 78, at IV-8. In fact, until a few years ago, board meeting minutes reflected "little discussion or direct involvement in policy considerations by the SBI, either as a result of questions from the Executive Director or through its own initiative." PMM PART II REPORT, *supra* note 76, at 10. In Ohio's SERS, the initiative for most investment related policies comes from the executive director. Interview with Thomas R. Anderson, *supra* note 69. For example, the investment policy statement included in the SERS 1979 Investment Report "for the use of the system's investment staff and counselors" was written by the board's legal counsel, investment advisor, and executive director. Risk levels for common stock are set annually by the board through a process of "general understanding in discussion with equity advisors." *Id.* Proposals for benefit increases, on the other hand, generally are initiated by the board.

89. PMM PART I REPORT, *supra* note 78, at IV-3.



board.<sup>90</sup> As a practical matter, the executive director has been the SBI's sole source of information when reviewing strategy and its implementation. Thus, the executive director has become the dominant force in establishing policy for the board's retirement funds.<sup>91</sup>

Communication between the SBI and the executive director has been inadequate. Because the board is given information consisting of unorganized excessive detail and statistics, it is difficult for the SBI to ask relevant and meaningful questions of the staff.<sup>92</sup> At the same time, the board has not received some information necessary to function properly.<sup>93</sup> The absence of regular and full communication and discussion between the board and its executive director severely hampers the effective administration of a retirement system by depriving the board of information essential to formulating appropriate policies and realistic investment goals, monitoring and evaluating performance in an intelligent and objective manner, and instituting appropriate changes in personnel and operations. Communication deficiencies also sow the seeds of misunderstandings, lack of confidence, and even distrust, thereby transforming the administration of the system into an adversarial rather than a cooperative process.<sup>94</sup>

The SBI has also lacked any formal procedures for evaluating management performance.<sup>95</sup> Without clearly stated and formally adopted policies, it is very difficult for the board to establish vehicles for measuring performance.<sup>96</sup> Without policies and performance standards, board expectations are not understood by fund managers and the board has no basis upon which

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90. *Id.* at I-5. In June of 1980, however, the SBI asked the IAC for advice on asset mix, performance objectives, and communications. PMM PART II REPORT, *supra* note 76, at 9. In October of 1980, the IAC issued recommended guidelines for each of the retirement funds. *Id.*

91. See PMM PART II REPORT, *supra* note 76, at 13.

92. PMM PART I REPORT, *supra* note 78, at IV-7; Interview with Arne H. Carlson, *supra* note 88.

93. For example, for a period of time the board had no knowledge of the existence of staff contracts with external vendors for performance measurement studies and reports. Interview with Arne H. Carlson, *supra* note 88. Similarly, until 1979, total return of the funds managed by the SBI were not reported to the board by the executive director. PMM PART II REPORT, *supra* note 76, at 15.

94. PMM PART I REPORT, *supra* note 78, at IV-11-12.

95. PMM PART II REPORT, *supra* note 76, at 19.

96. OFFICE OF THE STATE AUDITOR, SUMMARY OF REPORT ON STATE BOARD OF INVESTMENT 4 (Oct. 27, 1980); PMM PART I REPORT, *supra* note 78, at IV-8; PMM PART II REPORT, *supra* note 76, at 16.

to judge the effectiveness of management.<sup>97</sup> Although SBI minutes include salary reviews for the executive director and debates on the merits of the director's performance, there is no evidence that SBI decisions regarding the executive director were based on a formal evaluation of the director's performance and capabilities.<sup>98</sup> A lack of direction, expectations, and objective evaluation techniques fosters an attitude by a manager that a good performance is simply avoiding trouble, which is best accomplished by making money and avoiding controversy or scandal.<sup>99</sup> Thus, the board's task of monitoring and evaluating management performance becomes a reactive function. Such a situation perpetuates mediocre performance and encourages inappropriate reactions when the board is faced with fund losses or public criticism. Since there is no rational system for inquiry into the reasons for fund losses or criticisms, the board cannot effectively consider whether personnel or operational changes are warranted.<sup>100</sup>

The inefficiencies in the internal operation of the Minnesota system are compounded by state statutory requirements, which also exist in Ohio, that restrict investment flexibility by limiting investments to specified categories.<sup>101</sup> The statutes in both states, however, were amended last year to broaden the categories of permissible investments.<sup>102</sup> Minnesota substan-

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97. PMM PART I REPORT, *supra* note 78, at IV-9. A study of public transit systems discovered that without system policies "[b]usywork itself becomes a goal" of management. N. HAMILTON & P. HAMILTON, *supra* note 19, at 28. One interviewee went so far as to admit "[w]e sometimes come to the office and have no idea of what we want to do for the day." Furthermore, board evaluation of management performance necessarily is subjective when there are no policies which can serve as the basis for performance standards. *Id.* at 30.

98. PMM PART II REPORT, *supra* note 76, at 19.

99. "As long as management meets the budget constraint and is not involved in public scandal, it appears secure." N. HAMILTON & P. HAMILTON, *supra* note 19, at 30. One pension system executive director states that doing a good job means "number one, make sure money is wisely and productively invested and avoid scandals." Interview with Thomas R. Anderson, *supra* note 69. Examples of situations that would lead to the firing of an executive director include appropriation of fund assets for personal use, too close a link to a particular broker, and failure to disburse retirement checks in a timely fashion, or delay in answering correspondence. *Id.*

100. See A. WILLIAMS III, *MANAGING YOUR INVESTMENT MANAGER* 217-21 (1980) for a general discussion of a rational procedure for reviewing investment results, the possible reasons for poor investment performance, and the appropriate response in each case.

101. MINN. STAT. § 11A.24 (Supp. 1981); OHIO REV. CODE ANN. § 3309.15 (Page Supp. 1981). Many other states place similar restrictions on fund investments. See PENSION TASK FORCE REPORT, *supra* note 8, at 194.

102. See MINN. STAT. § 11A.24 (Supp. 1981); OHIO REV. CODE ANN. § 3309.15 (Page Supp. 1981).

tially increased the percentage of assets that can be invested in common stocks.<sup>103</sup> Notwithstanding these changes, some investments are still not available to these boards. Moreover, the boards themselves have restricted further their own investment flexibility.<sup>104</sup> Mandated investment restrictions, from whatever source, produce inherent inefficiencies in portfolio management and poor investment results.<sup>105</sup> Investment restrictions also hinder effective evaluation of management performance by allowing managers to use restrictions as an explanation or excuse for disappointing performance.<sup>106</sup>

Although a recent series of events in Minnesota formed a catalyst for inquiry and changes relating to SBI operations,<sup>107</sup> it

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103. See MINN. STAT. § 11A.24(5) (Supp. 1981).

104. For example, the SBI prohibits investments in tobacco and liquor as well as in certain infant formulas. Interview with Roger Henry, Equity Investment Manager of the Minnesota State Board of Investment, in St. Paul, Minn. (Aug. 11, 1981); interview with Lawrence A. Martin, *supra* note 83.

105. After discussing forms of investment restrictions, the Pension Task Force Report reached the following conclusion:

Clearly the various investment restrictions confronting public employee retirement systems hinder the efficiency of the total portfolio management of such plans. In fact, nearly one-fourth of the large state and local public pension plans responding to the . . . survey indicated that such restrictions impaired pension fund investment performance over the past five years.

PENSION TASK FORCE REPORT, *supra* note 8, at 197. See also R. TILOVE, *supra* note 6, at 203. The State Auditor of Minnesota notes that investment "constraints may now have a 'cost' exceeding any benefit—a cost of lost opportunity for SBI. If it were not prohibited by law, SBI could invest its money in other areas and obtain greater returns." OFFICE OF THE STATE AUDITOR, REPORT OF THE STATE AUDITOR OF MINNESOTA, SPECIAL REPORT ON STATE BOARD OF INVESTMENT, at 45 (Oct. 27, 1980). See also Gilkison, *Investment Approaches for Employee Pension Plans*, 1977 PUB. EMPLOYEES CONF. PROC. 123, 129.

106. Interview with Arne H. Carlson, *supra* note 88.

107. Among these events were a change in the SBI membership, a new executive director in 1979 who resigned in late 1981 under sharp criticism from one board member, the formal establishment of the IAC in 1980, persistent questions by one board member and others outside the board, public criticism of the system's fund performance, and the filing of a lawsuit in mid-1981 by one of the state retirement systems charging the SBI with breach of its fiduciary responsibilities through its alleged failure to discharge actively its duties. Trustees of the Minn. Pub. Employees Retirement Ass'n v. Minnesota State Bd. of Inv., No. 452938 (Minn. Dist. Ct. filed Aug., 1981, dismissed Jan. 22, 1982). See *infra* note 202. Discernible changes in SBI operations include a staff reorganization by the most recent executive director, the establishment of an executive committee to focus on policy issues, the adoption by the SBI of the IAC's written recommendations on investment objectives and asset mixes for each fund managed by the SBI, a gradual move toward greater interaction between the SBI and the IAC, direct reporting to the SBI by the outside consultant on comparative performance findings, and the passage of statutory amendments expanding the SBI's investment authority. See PMM PART I REPORT, *supra* note 78, at 3, 5, 8, I-2-3, I-5, I-14-15, IV-3, IV-5-7, IV-8; PMM PART II REPORT, *supra* note 76, at 9-11, 14-18; Young, *A Capital Fight*, 12 CORP. REP. MINN. 69 (1981); *The*

is clear that significant problems exist in the following areas: policy formulation; the delineation of powers and duties among the SBI, its executive director and staff, and the IAC; adequate communication and reporting among these bodies; the establishment of appropriate performance measurements; and formal evaluation procedures of the executive director and staff by the SBI. Most of the key issues in these areas are as yet unresolved. They are the subject of intense study and heated debate in what is often an adversarial atmosphere. Modification and change clearly are needed to insure better efficiency in the management of the retirement funds entrusted to the Minnesota SBI and other state retirement boards operating with similar problems and inefficiencies.

#### IV. PROPOSAL

##### A. LIMITATIONS

Proposed changes or modifications in the structure and operation of existing public retirement systems must be made in the context of three fundamental limitations. First, a theoretically perfect regulatory framework for retirement systems cannot cure existing problems that are not attributable to structural and operational deficiencies. Organizational changes will not make a poor manager or fiduciary a good one. The effectiveness of any system depends on the competence, integrity, and commitment of the individuals responsible for its operation.<sup>108</sup> The importance of the regulatory framework in which individuals operate should not be underestimated, however. The allocation of powers and duties, the definition of job functions, the communication of performance standards, the formalization of evaluations, and the response to both good and bad performance can affect the abilities and motivations of an organization's individuals to perform efficiently.<sup>109</sup> The role of the regulatory legal framework is to create those conditions

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*Challenge for State Investment Policy*, Minneapolis Tribune, Aug. 30, 1981, at 12A, col. 1; *Carlson, White Trade Insults at Investment Board Meeting*, Minneapolis Tribune, Aug. 28, 1981, at 3B, col. 1; *State's Investment Director Resigns*, Minneapolis Tribune, Aug. 25, 1981, at 11B, col. 5.

108. One scholar analyzes the economic activities of organizations based on a set of propositions including the fact that "the results of organizational behavior depend on the behavior of its individual members" and the fact that "individual performance depends on the specific effort choices of the individuals involved." H. LEIBENSTEIN, *GENERAL X-EFFICIENCY THEORY AND ECONOMIC DEVELOPMENT* 157 (1978).

109. *Id.* "A basic question rarely considered by development economists deals with the relationship between the organizational structure of the econ-

that will insure competent and honest personnel and, just as significantly, that will enable and encourage such individuals to perform efficiently.

The second limitation on proposing changes is the reality of the political environment in which public retirement systems operate and in which proposed changes must be made.<sup>110</sup> Many state retirement systems are large organizations with long histories of well entrenched attitudes, practices, and customs. The control of such large and well established organizations is also a source of political power. This does not mean, however, that a discussion of alternatives to existing regulation is an exercise in futility. Scholarship that points out the weaknesses of an existing structure and demonstrates the superiority of an alternative approach can help build or strengthen a constituency for the adoption of change. At the very least such scholarship can give politicians a publicly defensible alternative when under pressure from critics of the status quo.<sup>111</sup> To be realistic, however, any proposal must be politically feasible. Thus, "the real choices are often among alternative imperfect forms of control"<sup>112</sup> rather than between existing regulation and some ideal state. The following proposal recognizes that government control of public retirement systems is a political reality whether or not it is an ideal state.

Finally, this proposal is made in the context of a paucity of literature on the subject and a limited number of case studies.<sup>113</sup> A theory of legal structure cannot be proved at this stage. Therefore, the results of the actual utilization of these ideas are needed in order to judge the merit of this particular proposal. This proposal is offered in concrete and prescriptive terms in the hope of stimulating needed further study and constructive debate over the issue of public retirement system regulation and management.

The first part of the proposal recommends specific statutory duties that should be imposed on the board and actions that the board should take in compliance with these duties to insure a governance process aimed at fulfilling the control ob-

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omy and the motivating factors that influence organizational behavior." *Id.* at 156.

110. See T. BLEAKNEY, *supra* note 7, at 8-9, 13. See also R. SCHMALENSSEE, *supra* note 41, at 2.

111. R. SCHMALENSSEE, *supra* note 41, at 2.

112. *Id.*

113. The author is unaware of any public retirement system that uses all the ideas presented in this Article.

jective of portfolio selection efficiency. The second part of the proposal focuses on appropriate statutory standards for board membership, structure, and accountability that will minimize bureaucratic error and administrative cost.

## B. GOVERNANCE PROCESS

A public pension statute<sup>114</sup> should clearly identify portfolio efficiency as the control objective of the retirement board.<sup>115</sup> Governing public retirement systems for portfolio efficiency requires: 1) formulation of policies and performance guidelines for plan fund management; 2) management autonomy in implementing these policies and guidelines; and 3) incentives and pressures to encourage successful performance by those placed in control of the pension system. The corporate model commonly used to govern public employee retirement systems furnishes a logical structure for allocating functions between the policy-making retirement board and the policy-implementing investment manager, whether internal or external.

### 1. Policy Formulation

Since the proper objective of fund regulation is the maximization of financial return within a given level of risk, the primary policy issue facing the board is the appropriate level of risk to accept when investing fund assets. Risk policy formulation involves three steps: 1) the consideration of the fund's and sponsor's financial characteristics and external limitations; 2) the projections of such factors and the analyses of alternative investment policies; and 3) the translation of investment policy into operating objectives.

Step one includes consideration of fund characteristics such as fund size, the promised benefit scales, the employer and the employee contribution rates, the liquidity demands placed on the fund by retirees, the costs to operate the fund, and actuarial assumptions regarding investment return rates,

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114. "The single most critical control point is the law, decree, or other basic authority providing for the creation of a public enterprise. The nature of this action is likely to determine in large measure all other organizational relationships." Seidman, *The Government Corporation: Organization and Controls*, 14 PUB. AD. REV. 183, 185 (1954).

115. The purpose of Minnesota's public pension investment statute "is to establish standards which will insure that state and pension assets subject to this legislation will be responsibly invested to maximize the total rate of return without incurring undue risk." MINN. STAT. § 11A.01 (1980). Ohio has no comparable provision.

employee turnover, age profiles, life expectancies and salary increases.<sup>116</sup> The capability of the plan sponsor to fulfill its promise of providing retirees with the specified benefit payments in the event that fund assets and investment returns prove to be an inadequate source is also a factor that bears on a fund's appropriate level of risk, even when the plan sponsor is the government. Default by the government has become a greater possibility with an increased ratio of public employees to non-public employees, increased government borrowing, and the potential for taxpayer revolts.<sup>117</sup> Thus, when determining a risk level for a pension fund, the retirement board should consider the ratio of government contributions to total government revenues and trends in this ratio measured against historical experience.<sup>118</sup> The board should also consider government revenues in relation to the plan's unfunded vested liability and the impact of inflation on government revenues.<sup>119</sup> Finally, the board must consider such external factors as the current position of capital markets, the legal limitations on its investment power, and statutory restraints on budgetary, payroll and personnel policy.<sup>120</sup>

After considering the relevant internal and external characteristics of the fund and its sponsor, the second step in the policy formulation process is to make projections of these characteristics and to determine how alternative investment policies will affect these characteristics.<sup>121</sup> The long-term effect of a particular investment policy on the two key ratios of contributions as a percentage of payroll and plan assets as a percentage of plan liabilities may require re-evaluation of the plan's ability to accept risk.<sup>122</sup> Thus, it is important that the board make and analyze its projections on a long-term as well as a short-term basis. Such projections and analyses enable the board to define income, asset value, and liquidity requirements. This process also enables the board to make informed choices

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116. See, e.g., Levy, *How to Resolve that Critical Asset Mix Problem*, PENSION WORLD, Aug. 1978, at 58, 60.

117. See, e.g., A. WILLIAMS III, *supra* note 100, at 36-37. See generally PENSION TASK FORCE REPORT, *supra* note 8, at 95-99.

118. A. WILLIAMS III, *supra* note 100, at 37.

119. *Id.*

120. See, e.g., Stiteler, *Misuse of Actuarially Assumed Interest Rates in Determining Pension Investment Policy*, PENSION WORLD, May 1981, at 22, 26.

121. See, e.g., Grossman, *Developing Investment Policy and Statement*, PENSION WORLD, Dec. 1981, at 46-47.

122. *Id.* at 47.

among risk tolerance levels and investment management styles.

Once the board has selected an investment policy, the final step is to translate it into clear and consistent operating objectives.<sup>123</sup> Operating objectives provide concrete direction to the investment manager, reducing the likelihood of "management by crisis,"<sup>124</sup> and give the board a concrete standard against which to evaluate the manager's performance. Without objectives, evaluation either will not occur or will be made on the basis of obvious minimum standards.<sup>125</sup> Thus, the board's investment policies must be translated into return objectives, asset mix and investment media maximums, and risk tolerance levels.<sup>126</sup>

The importance of this policy formulation process cannot be overestimated. Formulating policy and translating it into operating objectives affects the board's ability to fulfill its control objective.<sup>127</sup> The process assists the board in planning for the future by forcing it to evaluate existing and projected fund assets and liabilities. This evaluation in turn enables the board to analyze and choose among alternative investment approaches. Operating objectives help direct management development by identifying objectives of individuals with objectives of the system, by making the objectives specific, and by creating a means of measuring the success of individuals in meeting their specified objectives. Planning for the future, analyzing and choosing among alternative courses of action, and developing the potential abilities of the individuals charged with daily operations increase effectiveness and efficiency in the use of the system's funds.

In order to engage successfully in the policy formulation process, the board needs resources to collect, project, analyze, and comprehend relevant data relating to investments, economics, finances, actuarial science, accounting, and statistics.<sup>128</sup> Furthermore, such activities require a board whose members

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123. An operating objective is an unambiguous statement of policy "that directly guides management action but allows for management expertise to choose the operational strategy to reach the objective." N. HAMILTON & P. HAMILTON, *supra* note 19, at 9. See also Granger, *The Hierarchy of Objectives*, HARV. BUS. REV., May-June 1964, at 63, 66.

124. N. HAMILTON & P. HAMILTON, *supra* note 19, at 97-98.

125. *Id.* at 9, 99.

126. See, e.g., Grossman, *supra* note 121, at 48.

127. Practical uses of objectives are identified and discussed in Granger, *supra* note 123, at 71-74.

128. See *infra* text accompanying notes 188-91.



are familiar with these subjects and who are willing and able to commit the time and energy necessary to fulfill board duties.<sup>129</sup> Finally, the board needs to be accountable for the degree to which, and the manner in which, it successfully fulfills its control objective of portfolio efficiency.<sup>130</sup>

## 2. Policy Implementation

Under the corporate model, policy implementation is the responsibility of an investment manager selected by the board. It is essential that the board carefully select its manager, give the manager the authority and autonomy to operate the plan on a day to day basis, and maintain open and effective lines of communication with the manager.

One of the most important tasks facing the board is the selection of an investment manager who will implement board policies.<sup>131</sup> Before selecting a manager, the board must decide whether to use internal or external management, how many investment managers to use, whether to use special or general managers, and what management style is appropriate for fulfilling the board's policies.<sup>132</sup> Decisions on these management structure issues will enable the board to establish selection criteria and create a master candidate list from which to choose the investment manager(s).<sup>133</sup>

In evaluating specific candidates, the board should inquire into the manager's work load, philosophy and performance history, and determine how he or she proposes to handle the transition from the existing portfolio to the final portfolio reflecting the investment choices of the manager and the board.<sup>134</sup> The board must ascertain the extent to which the manager is conversant with current theories and techniques found in the respected body of financial microeconomic literature. The

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129. See *infra* text accompanying notes 178-87.

130. See *infra* text accompanying notes 192-205.

131. "[T]his responsibility entails choosing someone to manage millions—sometimes billions—of dollars and to make investment decisions which will affect the future of countless employees." Michaelis, *Five Questions to Ask Prospective Money Managers*, PENSION WORLD, Apr. 1979, at 24.

132. See, e.g., A. WILLIAMS III, *supra* note 100, at 71-116; Haight, *Investment Management-Internal or External?*, PENSION WORLD, Nov. 1980, at 20; Minard, *Time to Re-Examine*, PENSION WORLD, July 1980, at 14, 15-16; Vaughan, *Perspective on the 1980's*, PENSION WORLD, Aug. 1980, at 24.

133. See, e.g., Chittim & Yanni, *Money Manager Selection: The Business Decision*, PENSION WORLD, Feb. 1980, at 17, 18.

134. See, e.g., A. WILLIAMS III, *supra* note 100, at 104-16; Chittim & Yanni, *supra* note 133, at 19; Michaelis, *supra* note 131, at 30-31; Minard, *supra* note 132, at 16-17.

board should investigate the manager's existing, in the case of external management firms, or proposed, in the case of internal managers, internal organizational structure. The board needs to know how the manager gathers and uses information, makes investment decisions, and employs incentive compensation systems for personnel. The board should investigate the manager's staff and resource capabilities and internal review procedures.<sup>135</sup> Finally, the board must evaluate the chemistry between the board and the manager. The manager must be one in whom the board can place its trust, who is accessible and attentive to fund matters, and with whom the board can communicate effectively.<sup>136</sup>

The board should give the investment manager broad power and autonomy to manage the fund within the scope of the board's operating objectives. Creating and executing the investment strategies most effective in fulfilling operating objectives require both full-time work and a thorough knowledge and understanding of the investment management business.<sup>137</sup> This includes a working knowledge of capital markets, financial statistics, information resources, theories, and techniques. Because the investment manager is more likely to have the time and knowledge, he or she presumably is in a better position than the board to make productive use of plan funds in the pursuit of the system's control objective of portfolio efficiency.

Investment constraints, in whatever form, ultimately lead to waste and lost opportunities.<sup>138</sup> For example, many systems impose screening procedures requiring the manager to present, justify, and obtain board approval for investment decisions before they are executed. Such a procedure severely hampers the manager's ability to respond quickly to market changes and to make a continuing and consistent succession of investment decisions.<sup>139</sup> Even where the manager is authorized to take ac-

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135. See, e.g., A. WILLIAMS III, *supra* note 100; Chittim & Yanni, *supra* note 133; Michaelis, *supra* note 131; Minard, *supra* note 132.

136. See, e.g., Chittim & Yanni, *supra* note 133, at 20; Hydrick, *Is George Patton Going to Manage Your Money?*, PENSION WORLD, June 1981, at 48, 81; Michaelis, *supra* note 131, at 32.

137. For a discussion of the advantages of management autonomy in the area of public transit, see N. HAMILTON & P. HAMILTON, *supra* note 19, at 100.

138. See *supra* note 105.

139. See, e.g., R. TILOVE, *supra* note 6, at 212; Michaelis, *supra* note 131, at 28. OHIO REV. CODE ANN. § 3309.15 (Page Supp. 1981) provides that "[n]o investment shall be made . . . without prior approval by the . . . board." Ohio's SERS board provides its investment officer with an approved list of stock investments. Interview with Thomas R. Anderson, *supra* note 69.

tion under exigent circumstances, many systems require subsequent board ratification.<sup>140</sup> The need to justify individual decisions and the risk of board disapproval can inhibit the manager's willingness to act.

Similarly, board investment lists, prohibitions, or mandates impede investment flexibility.<sup>141</sup> A board prohibition against investments in venture capital firms because they are "too risky" offers an example of unwarranted board interference in decisions more appropriately left to management. At first blush, venture capital firms, in terms of total risk, may appear to be "too risky." Since diversification can virtually eliminate firm specific risk,<sup>142</sup> however, the relevant issue is the level of systematic risk<sup>143</sup> of a venture capital firm. The systematic risk of a venture capital firm may well match the risk preference of a particular state pension fund. Venture capital firms, therefore, should be part of the universe of investments available to the fund manager.

Recent financial literature indicates that in order to maximize wealth, a tax-exempt investor should invest in securities with the greatest difference between pre-tax and post-tax returns without disruption of the match between the securities' risk and the investor's risk preference.<sup>144</sup> Since the return on debt is more heavily taxed than the return on equity,<sup>145</sup> the issuer of debt must offer a greater rate of return relative to sys-

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140. The investment officer of the Ohio SERS is authorized to sell stock upon the recommendation of the board's investment counsel if there is a risk of decline in the stock's market value or a risk of financial impairment of the company issuing the stock. The investment officer must first inform the investment committee of the board, however, if such a sale would result in a loss to the fund. Interview with Thomas R. Anderson, *supra* note 69.

141. See, e.g., Gillison, *supra* note 105, at 128-29. For a discussion of the potential underdiversification resulting from investment restrictions, see *supra* notes 24-26 and accompanying text.

142. See *supra* note 26.

143. See *id.*

144. Black & Dewhurst, *A New Investment Strategy for Pension Funds*, 7 J. PORTFOLIO MGMT. 26 (1981).

145. If a corporation accumulates its earnings rather than distributes them to its shareholders, its stock will appreciate in value and the appreciation will be taxed at capital gain rates upon the sale of the stock. In contrast, distributed corporate earnings are taxed as dividend income at ordinary income rates. The only return received on a debt investment, however, is the interest earned on the obligation owed by the corporation which is taxed like dividend income at ordinary income rates.

An equity investment in a mutual fund company receives even more favorable tax treatment, since it entitles the shareholders to receive dividends on a capital gains basis to the extent of the shareholders' portion of the capital gains earned at the corporate level.

tematic risk than the issuer of equity. Earnings from pension fund investments are not taxed. Thus, tax-exempt investors, such as pension funds, can capture this excess pre-tax return by investing in debt rather than equity.<sup>146</sup> Under these circumstances, failure to invest in debt means the investor is not maximizing wealth. The validity of such a theory, however, does not justify a statutory or board prohibition of equity investments. Circumstances could change making it appropriate for pension funds to invest in equity. The universe of investment vehicles, therefore, should be available to afford the manager the flexibility to use valid financial theories as they develop and as circumstances warrant. The only appropriate constraint on the investment manager is one of rationality in pursuing maximum return at an appropriate risk level.

The successful implementation of board policy depends not only on the competence and autonomy of the management but also on the nature of the communications between the board and management. Management obviously must know the nature of its responsibilities and the extent of its discretion and authority in fulfilling those responsibilities. Without such knowledge, management operates in a vacuum with little or no direction. Thus, it is essential that the board clearly communicate its policies and objectives in writing to management. In addition, continuing and open communication with the board about management's strategies, studies, procedures, and internal evaluations enables the board to monitor and evaluate the performance of management.<sup>147</sup> It also gives management an opportunity to provide the board with financial and investment data, an appraisal of the feasibility of proposed objectives, and suggestions regarding available investment alternatives.<sup>148</sup> Fi-

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146. The following example, although extreme in its assumptions, illustrates the point. Suppose an equity investment has a risk level of 2 and an expected return of \$100 that is not taxed, and the return on a debt investment with a risk level of 1 is subject to a 50% tax rate. Suppose also that, because the debt is half as risky as the equity, the debt would have to offer half the return, or \$50, if it were not taxed. But since it is taxed, the post-tax return on the debt is only \$25. The debt issuer, in order to compensate for this tax effect, must offer taxed investors a pre-tax return of \$100, thus making the post-tax return one-half of the equity's expected return in accordance with the respective systematic risk levels of each investment. The tax-exempt investor can capture a \$100 return through the debt investment and incur only half the risk of the equity investment offering the same expected return. Investing in the debt under such circumstances obviously maximizes wealth for the tax-exempt investor.

147. See *supra* text accompanying notes 86-107; A. WILLIAMS III, *supra* note 100, at 219, 221-24. See, e.g., PMM PART II REPORT, *supra* note 76, at 8, 12, 14, 31-32, 35-38.

148. See generally A. WILLIAMS III, *supra* note 100, at 219, 221-24.

nally, regular channels of communication help prevent misunderstandings and distrust between the board and management. It is only in an atmosphere of mutual confidence and respect that the control and operation of the system will be a cooperative venture between the two distinct yet interdependent bodies.<sup>149</sup>

### 3. *Performance Incentives*

#### a. *Competitive Pressure*

Providing an investment manager with operating objectives and the autonomy and authority needed to fulfill those objectives does not ensure portfolio efficiency. Competition is a necessary condition for the production of goods at the lowest cost.<sup>150</sup> It fosters the development and adoption of the most effective methods of production.<sup>151</sup> In the private sector, competition automatically roots out inefficient producers through their inability to maintain adequate profit levels. In the public sector, on the other hand, production efficiency<sup>152</sup> is primarily achieved by evaluating production processes through performance measurements.<sup>153</sup>

There are two basic ways to introduce competition into the management of public employee retirement funds. One is interfund competition through performance comparisons among

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149. See, e.g., Gilkison, *supra* note 105, at 128. In the words of two authors: [L]ike a marriage, it will take time to get to know, understand and trust one another. Open communication and patience is essential in any good marriage, particularly one between a [board] and its pension fund money manager. If there's any single point we would emphasize in this paper, it is "Don't stop talking to each other."

Chittim & Yanni, *supra* note 133, at 20.

150. For a discussion of the process called "economic darwinism" whereby goods are produced at the lowest cost through "natural selection" in the free market, see N. HAMILTON & P. HAMILTON, *supra* note 19, at 50-52, 101.

151. See generally A. WILLIAMS III, *supra* note 100, at 225-26.

152. Production efficiency in pension funds translates into investments which realize specified returns at the lowest possible risk or, alternatively, realize the highest return possible at a specified level of risk.

153. Tilove notes that:

In government systems [the] direct profit motive does not exist. If investment yield is superior, it is not generally clear who will profit: the public employer (by way of an abatement of contributions), or the employees (perhaps because the extra yield is credited to employee-contribution accounts, or because any extra margin is often considered an appropriate basis for benefit improvements). In any case, no one party is as strongly motivated as the corporate executive to improve investment yield.

R. TILOVE, *supra* note 6, at 215. Thus, the board must measure and evaluate management performance and implement appropriate responses to inefficient management. See *infra* notes 165-74 and accompanying text.

existing systems.<sup>154</sup> The obvious difficulty in making such comparisons, however, is that all public employee retirement fund managers do not operate under the same conditions. Variables such as fund size, operating objectives, investment constraints, and research and staff support can have a significant impact on investment returns independent of the capabilities and efforts of management.<sup>155</sup>

A second method of introducing competitive pressure into retirement fund management is to use multiple investment managers, each of whom is in charge of an equal portion of the fund and has the same operating objectives.<sup>156</sup> Investment managers whose jobs or salaries depend on producing higher returns than each other without going outside the board's investment guidelines will have a natural incentive to devise the most efficient portfolio.<sup>157</sup> In addition, the board will be better able to evaluate different management investment approaches by comparing investment results, and thus will be able to eliminate inefficient management. Multiple managers also can be used in systems that directly employ inside management. Each manager, however, will want his or her own staff, since the staff is an important variable in the manager's ability to perform efficiently and to fulfill operating objectives. The cost of employing more than one manager each with his or her own staff is likely to exceed what private investment firms would charge for the same fund management services.<sup>158</sup> Moreover, government finds it difficult to attract and retain competent managers because of the pressures and vagaries of the political

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154. For a discussion of various comparative services available, see Derven, *Essential Aids In Keeping Pension Funds on Target*, PENSION WORLD, Aug. 1981, at 45. See also A. WILLIAMS III, *supra* note 100, at 213. Self-imposed competition can result from a desire to do better than managers of other public funds both within and outside the state. Interview with Thomas R. Anderson, *supra* note 69.

155. See, e.g., Levy, *Common Sense and Comparative Performance*, PENSION WORLD, Apr. 1978, at 8. One of the current controversies between the Minnesota SBI and investment staff is the proper universe to use when comparing investment performances. Interview with Arne H. Carlson, *supra* note 88; Interview with Roger Henry, *supra* note 104; Interview with Lawrence A. Martin, *supra* note 83.

156. It should be noted that multiple managers are used for specialization purposes as well as for diversification reasons. That is, "sponsors have come to feel that they are unlikely to find the best bond manager and the best stock manager within the same firm, so they seek organizations which specialize in one asset category or another." A. WILLIAMS III, *supra* note 100, at 225.

157. More graphically stated: "The sheer threat of losing to a better manager will serve as a blowtorch on the behind of the manager." Gilkison, *supra* note 105, at 127-28.

158. See, e.g., A. WILLIAMS III, *supra* note 100, at 225.

arena in which management must operate.<sup>159</sup> Managers find the public sector less attractive because of the government's inability or unwillingness to offer salaries and incentive-compensation packages competitive with private investment management firms.<sup>160</sup>

Alternatively, the board can attempt to put competitive pressure on inside management by hiring a private firm to manage a portion of the fund's assets. The same problems associated with internal management will exist, however, and unless inside management is given similar staff, research support, and compensation incentives, fair performance comparisons will be difficult to make.

The solution to the problems of internal management is to use private investment management firms exclusively. The board could contract out the management of all fund assets to two or more private firms which would compete between or among themselves. It may be more difficult and costly, however, for the board to hire and monitor the performances of multiple outside managers than it would be to hire and monitor a single firm.<sup>161</sup> In such a case, a more effective means of introducing competition may be to have contract management firms bid for the opportunity to manage the fund for a prescribed term.<sup>162</sup> The board could present prospective managers with relevant fund data and board objectives and have them compete for the contract by submitting bids detailing their fees, investment style, proposed strategies, and return/risk projections.<sup>163</sup>

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159. See, e.g., N. HAMILTON & P. HAMILTON, *supra* note 19, at 107.

160. There is considerable scholarly opinion to support the proposition that a sense of public duty is an insufficient motivator. For example, Bergson, *Managerial Risks and Rewards in Public Enterprises*, 2 J. OF COMP. ECON. 211, 215 (1978) states, "[M]anagers are only interested in their own expected utilities, and must be induced to maximize expected benefit to the community by penalties and rewards which depend on the benefit produced." In the words of another scholar, "Individuals in the bureaucracy, like the rest of us, do react to different incentive schemes. . . . They prefer more rather than less income, power, prestige, pleasant surroundings, and congenial employees. . . ." Davies, *Foreward* to BUDGETS AND BUREAUCRATS: THE SOURCES OF GOVERNMENT GROWTH at xi-xii (T. Borchert ed. 1977). See also Dornstein, *Managerial Theories, Social Responsibility and Goal Orientations of Top Level Management in State-Owned Enterprise*, 5 J. OF BEHAV. ECON. 65, 81, 85 (1977). Compensation packages adequate to attract and keep the best investment professionals from the private sector require salaries exceeding those of most states' highest elected officials. Providing such compensation, however, is politically impossible.

161. See *supra* note 151.

162. See generally N. HAMILTON & P. HAMILTON, *supra* note 19, at 105-09.

163. The lowest bid for management fees may have little relation to the

With the exclusive use of outside management, inside management would be eliminated or transformed into a consulting body.<sup>164</sup> This body could be helpful in the areas of investment policy formulation, management selection, monitoring, and evaluation. It could be responsible for collecting and analyzing relevant data, testing alternative investment policies, recommending operating objectives and performance measurements, and performing any special studies requested by the board.

#### b. Review Procedures

Competitive pressures on management need to be complemented by a system of review procedures to identify inefficient management. A thorough review process requires meeting periodically with management, establishing performance measurements, evaluating management performance, and establishing and carrying out responses to inadequate performance.<sup>165</sup> Periodic face to face meetings between the board and manager force the manager to articulate the investment strategy being used, the reasons for its use, and plans for future strategies. These meetings also provide the manager with the opportunity to explain to the board the impact of market activities on the prospects of meeting investment objectives. This information helps the board review its own policies and objectives as well as evaluate the adequacy of the manager's performance. If such meetings occur too often, however, they can cause the board to focus on short-term performance and inadvertently involve the board in management activities.<sup>166</sup> Fur-

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ability of the bidder to produce the highest return. The board obviously will have to look to the qualifications of the bidders and the reasonableness of each of the bids' assumptions and projections to eliminate the "adventurous" bid. The non-fulfillment of performance projections should be taken into account during the board's periodic evaluations of management. See *infra* text accompanying notes 165-74. In addition, minimum performance guarantees can be required. Some funds use such financial incentives whereby a manager receives a bonus if he outperforms a specific index and refunds a portion of his fee if he underperforms. See OFFICE OF THE STATE AUDITOR, *supra* note 105, at 40.

164. See generally Levy, *The Independent Pension Consultant: What Can He Do For Your Fund?*, PENSION WORLD, Nov. 1978, at 41.

165. See, e.g., A. WILLIAMS III, *supra* note 100, at 212-24.

166. *Id.* at 213-15. See also Gilkison, *supra* note 105, at 128. Although bi-annual or quarterly meetings may be held, the focus of such meetings should be information exchange, not formal evaluation. Generally, the formal evaluation should be made after completion of a market cycle. *Id.* Accord Interview with Arne H. Carlson, *supra* note 88. Another commentator has noted the value of foregoing impromptu evaluations:

Clearly, sponsors should allow their managers to demonstrate their skills both when their style is "in favor" and when not in favor. To hire a manager after his type of holdings have done well and perhaps



thermore, preparation for frequent meetings prevents the manager from focusing on the daily details of managing the fund and prevents the board from focusing on policy issues. These meetings, therefore, should not be held too frequently and should be conducted only for the purpose of communicating information, such as economic outlooks, interest rate predictions, stock market prognoses, and recent past events in these areas, that will be useful to policy formulation and performance evaluation.

Effective board review requires the adoption of quantifiable performance measurements.<sup>167</sup> The absence of objective standards to measure the relative degree of management's attainment of operating objectives leads to subjective evaluation. A lack of standards also encourages a manager to exert only the minimal degree of effort he or she believes will satisfy a review.<sup>168</sup>

The board should judge management performance in terms of the board's operating objectives and comparative performance data. These dual forms of measurement enable the board to assess the significance of a manager's failure or success in fulfilling objectives.<sup>169</sup> For example, the failure to achieve board objectives by a manager who outperforms other managers with whom he or she is being compared<sup>170</sup> could be attributable to unpredictable swings in the market beyond the manager's control. The failure, however, could be attributable to the adoption of infeasible policies and objectives or to the board's inadequate communication of its policies and objectives to the manager. In other words, a thorough evaluation of management performance goes beyond performance measurements. It requires the board to explore the reasons behind the perform-

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peaked, only to fire him in the next stage of the cycle when his securities have done poorly, demonstrates precipitous and irrational behavior. Sponsors can be whipsawed when, having dismissed a manager whose style was out of favor, the stocks rebound with the market, and the sponsor has missed the boat twice.

Minard, *supra* note 132, at 18.

167. Numerous measurement techniques are available, including various market indices and performance comparison services. The 1975 Securities Act Amendments made available new performance data on investment advisors that a retirement plan board should find useful in comparing the performance of its management to that of other investment managers. See Levy, *Investment Advisors Performance: A Secret No More*, PENSION WORLD, Aug. 1979, at 22. See also A. WILLIAMS III, *supra* note 100, at 117-40; Derven, *supra* note 154, at 45.

168. See *supra* note 99.

169. See, e.g., A. WILLIAMS III, *supra* note 100, at 213, 215-16.

170. The converse, of course, can exist. That is, the manager may fulfill board objectives but underperform other comparable managers. *Id.* at 216.

ance statistics. The board, therefore, should 1) view the manager's activities in terms of the manager's stated strategy to achieve board objectives and professed style of management; 2) monitor changes in the manager's internal structure, policies, and execution capabilities; 3) review the manager's willingness and ability to communicate with the board; and 4) establish the levels of underperformance that the fund can tolerate.<sup>171</sup>

After the evaluation of all these aspects of the manager's performance, the board must respond appropriately.<sup>172</sup> The appropriate response to mediocre or unsatisfactory performance can range from a review and revision of the board's own policies, objectives, and communication procedures to forcing the manager to take corrective action to replacing the manager. The board should also respond to superior performance. Appropriate responses here might include contract renewals, increased fees, and public statements of commendation.<sup>173</sup> By imposing the pressure of competition on management, thoroughly evaluating management performance, and making management directly bear the consequences of its abilities and efforts, the board can come as close as possible to ensuring the fulfillment of its policies and objectives in furtherance of its own control objective.<sup>174</sup>

#### 4. *Statutory Mandates*

To insure the creation of conditions necessary for portfolio efficiency, the statute should empower and direct the board to do the following: 1) formulate investment policies based on

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171. *Id.* at 221-24. See also Minard, *supra* note 132, at 17.

172. For a discussion of how to establish appropriate responses, see A. WILLIAMS III, *supra* note 100, at 217-21. The response will be affected in part by the ranges of underperformance the fund can tolerate. Thus, the board must establish allowable tolerances for underperformance in order to define an appropriate response. *Id.* at 213, 215. Furthermore, because replacing a manager "can be an expensive and fruitless process . . . it is helpful to consider ways in which . . . difficulties can be corrected while still retaining the manager." *Id.* at 220.

173. For a discussion of financial rewards and punishments, see *supra* note 163.

174. See generally H. LEIBENSTEIN, *supra* note 108, at 163-71 for a discussion of X-efficiency variables, i.e., an organization's structural, environmental, and procedural characteristics which affect its economic efficiencies. These variables are identified as (1) the extent to which an individual is made to bear the consequences of his activities; (2) pressure from authorities and peers; (3) cost constraints, including (a) standards of performance, (b) maximum revenue available to an organization, (c) the degree of competition, and (d) the degree of bureaucratic control; and (4) individual effort. *Id.*

short and long-term projections and analyses; 2) produce a written statement of policies; 3) adopt a clear statement of operating objectives consistent with board policies; 4) develop appropriate methods for measuring the performance of operating objectives;<sup>175</sup> 5) select qualified investment management;<sup>176</sup> 6) create competitive pressure for management; and 7) establish and implement periodic management performance review procedures.

### C. GOVERNING BOARD

Even with such statutory directives, the board can make mistakes through statutory misconstructions, incompetence, and the use of inaccurate or insufficient information. A statute cannot eliminate the misjudgments of those responsible for its implementation, but it can reduce the likelihood of bureaucratic error and administrative cost.<sup>177</sup> The standards it demands of administrators determine in large measure the success with which the pension system will achieve its objective.

#### 1. *Board Members*

If a pension act is to reduce administrative error, it must require board members to be qualified, independent, and free to devote time and energy to their board duties. A basic understanding of statistics, accounting, economics, finance, investment theories, and business management, acquired through education or experience, should be required of all board members. The board should be large enough to ensure diversification of skills and experiences in order to promote board

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175. MINN. STAT. § 11A.04(11) (1980) directs the SBI to "[e]stablish a formula or formulas to measure management performance and return on investment. All public pension funds in the state shall utilize the formula or formulas developed by the state board." One interviewee cited this provision as an example of the fact that things are not always run as the statute provides. Interview with Lawrence A. Martin, *supra* note 83. Furthermore, this provision apparently has been construed as not requiring funds to calculate and report investment returns, but only requiring that such calculations, if done at all, be done according to the established formula.

176. See *supra* note 86 and accompanying text.

177. "It is a reasonable assumption that legal structure and the minimization of error in policy determination and production are inextricably linked, since it is the structure of the board which in large part defines the information available, the competence and motivation of the board, and the decision-making procedure." N. HAMILTON & P. HAMILTON, *supra* note 19, at 114. See generally H. LEIBENSTEIN, *supra* note 108, at 156-80 (organizational factors in production efficiency).

competence. A multi-member board will bring different points of view and experiences to board deliberations, thereby discouraging arbitrary and capricious board action.<sup>178</sup>

Board members also should be independent. That is, they should be free of any conflicting interests<sup>179</sup> or undue vulnerability to political pressures.<sup>180</sup> Statutory provisions can help ensure board independence by requiring potential and current board members to disclose their financial investments, sources of income, and business and family relationships. Although the board is not responsible for individual investment decisions, employment or substantial interests in a particular industry or investment medium have the potential for influencing a member's investment policy decisions. Similarly, a business or family relationship to any individual or firm under consideration by the board for employment or a contract award can bias a board member. Board members should be required to withdraw from any board deliberations regarding a matter that involves potential conflict.<sup>181</sup>

To avoid political pressure on board members, which can deprive them of independent judgment, members should be nonelected officials with fixed terms of office.<sup>182</sup> Elected officials are subject to strong interest group lobbying and are affected by the need or desire to gain support of key groups of voters. Such influences increase the possibility of decisionmaking errors. Fixed terms for board membership can foster board independence from organized interest groups.

Additionally, the statute can further board independence

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178. See, e.g., Redford, *The Arguments For and Against the Commission System*, in *THE POLITICS OF REGULATION* 124 (S. Krislov & L. Musolf eds. 1964).

179. See, e.g., J. THURSTON, *GOVERNMENT PROPRIETARY CORPORATIONS IN THE ENGLISH SPEAKING COUNTRIES* 159 (1937).

180. See, e.g., Redford, *supra* note 178, at 123-24.

181. MINN. STAT. § 11A.08 subd. 6 (1980) (amended 1981) requires members of the Investment Advisory Council to file an economic interest statement and to refrain from participating in council deliberations and votes which "will or [are] likely to result in direct, measurable economic gain to the member." As trustees, board members are subject to common law trust prohibitions against self-dealing. See RESTATEMENT (SECOND) OF TRUSTS § 170 (1959). Recent amendments to OHIO REV. CODE ANN. § 3309.156 (Page Supp. 1981) adopt investment standards and prohibit certain transactions by board members.

182. The Ohio Attorney General has interpreted the state enabling legislation for transit authorities as prohibiting elected officials from serving as board members. N. HAMILTON & P. HAMILTON, *supra* note 19, at 135. The prohibition against elected officials serving as board members obviously should extend to non-civil service employees of elected officials who, because of their positions, are also more vulnerable to political pressures.

by freeing the board from the government budget.<sup>183</sup> Using plan funds to pay for board expenses, rather than a legislatively allocated portion of government revenues, reduces the uncertainty regarding the board's financial ability to secure and maintain necessary qualified staff, consultants, and investment managers. It also reduces the possibility of legislative interference in board activities through pressure on the board to adopt a particular investment policy or to retain or dismiss a particular investment manager in exchange for budget approval.

If the board is to play a vital and active role as policymaker and performance monitor, it is essential that board members devote the time and energy that is necessary to perform board responsibilities fully. Although the public recognition and prestige involved in serving on a retirement board, the challenge of the work involved, and personal satisfaction derived from fulfilling one's civic duty may help encourage qualified individuals to accept board membership and to discharge board duties conscientiously, such factors are not sufficient alone.<sup>184</sup> To allow board members to devote adequate time to board activities, the statute should provide for compensating board members in an amount comparable to that paid directors of organizations engaged in similar activities.<sup>185</sup> Statutory mandates that board members take part in periodic training programs<sup>186</sup> and attend a specified number of board and com-

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183. See, e.g., J. THURSTON, *supra* note 179, at 256.

184. See *supra* note 160.

185. Neither Ohio nor Minnesota compensates board members beyond their expenses. To avoid the need for repeated legislative amendments regarding board compensation, the statute should empower the state auditor to determine an appropriate compensation level based on a survey conducted by the auditor's office every three years. See N. HAMILTON & P. HAMILTON, *supra* note 19, at 117-18 for a discussion of the defects in a compensation arrangement based on meetings attended. Note also that "the argument . . . that compensating board members will lead to the appointment of unqualified candidates on the basis of patronage . . . is unsubstantiated, and there is evidence suggesting the opposite." *Id.* at 117.

186. Such programs should not serve as remedial courses in investments, finance, or community concerns since only individuals already possessing such knowledge should qualify for board membership. N. HAMILTON & P. HAMILTON, *supra* note 19, at 115-16. Rather, these programs should offer board members training in the operations of public retirement systems and an awareness of the current issues confronting the system. The need for such programs is apparent in Minnesota where "there is no orientation program or any program that could even remotely be regarded as training." OFFICE OF THE STATE AUDITOR, *supra* note 105, at 4. In Ohio, SERS board members attend an in-house orientation which is essentially an opportunity to meet each other and the staff. They also attend a new trustees conference sponsored by the International Foundation of Employee Benefit Plans for an introduction to such topics as the role of an actuary, the legal nature of a board member's status as a fiduciary, and determi-

mittee meetings, noncompliance with which would be cause for immediate removal from the board,<sup>187</sup> would insure a minimal time and attention commitment to board matters.

## 2. Board Structure

Because board members are not experts in the numerous fields related to public retirement systems, they need a well informed staff and outside consultants to help gather, analyze, and use vast quantities of technical and general data essential to policy formulation, fund evaluation, and management review. The statute should direct the board to hire needed personnel and consultants.<sup>188</sup> The board should be provided with an adequate budget or the authority to charge the pension fund for reasonable expenses.<sup>189</sup>

Board committees can also facilitate board performance.<sup>190</sup> Through the use of committees, a board member can specialize in one of the areas of board responsibility. Specialization broadens board experience and increases the thoroughness and efficiency with which the board performs its planning, hiring, monitoring, measuring and review functions.<sup>191</sup>

## 3. Board Accountability

Even if the measures suggested so far are incorporated into a statutory scheme, they will not ensure that the board will fulfill its control objective, unless the legal structure also includes provisions assuring board accountability.<sup>192</sup> Arguably, one

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nation of a fund's investment return. Interview with Thomas R. Anderson, *supra* note 69.

187. Under OHIO REV. CODE ANN. § 3309.06 (Page 1980), a board member is deemed resigned if he or she misses board meetings for four months.

188. MINN. STAT. § 11A.04 (1980) provides that the SBI "shall . . . (4) [e]mploy investment advisors and consultants as it deems necessary." Similarly, the SERS board "shall secure the service of such technical and administrative employees as are necessary for the transaction of the business of the . . . system." OHIO REV. CODE ANN. § 3309.14 (Page 1980).

189. As discussed above, however, board independence is furthered by its freedom from the government budget. See *supra* note 183 and accompanying text.

190. Ohio's SERS board has separate committees responsible for disability benefits, retirement benefits, and ad hoc personnel. The investment committee is a committee of the whole. Interview with Thomas R. Anderson, *supra* note 69. This proposal envisions a further subdivision with respect to the board's investment responsibilities. See generally N. HAMILTON & P. HAMILTON, *supra* note 19, at 116-17.

191. The enabling statute should not specify the number or purpose of board committees, but rather, should direct the board to establish the committee structure most appropriate to efficient functioning.

192. "[A]ccountability has to be sought in a far wider range of affairs: the

method of assuring accountability is the direct election of board members by state residents.<sup>193</sup> Direct election avoids the back-door political influence inevitable in a public appointment process. In theory, it also results in better representation of the general populace affected by board actions. Direct election of officials responsible for administering public retirement pensions, however, has several serious drawbacks. First, fewer people are likely to vote in an election for retirement board members than in national and statewide elections for executive and legislative representatives. Second, voters are unlikely to understand the nature of the board's responsibilities, the activities the board must engage in to fulfill its responsibilities, and the qualifications of board members to perform board activities. Third, the politics of the election process can lead board members to overemphasize the taxpayers' unwillingness to pay higher taxes and the social interests of various voter groups at the expense of the financial retirement needs and desires of plan participants and their beneficiaries in investment risk level determinations. Pressure by various voter groups to use retirement system funds to advance their social and economic interests would lead to the pursuit of investment goals other than the maximization of financial return to plan participants within reasonable risk levels. It could also lead to board review of management's individual investment decisions for their social "desirability," rather than for portfolio efficiency. Sensitivity to taxpayer and public employee concerns can be encouraged through means other than the direct election of board members, such as statutory restrictions on the number of a member's successive terms,<sup>194</sup> and gubernatorial appointment of board members nominated by a citizens' advisory committee and confirmed by the legislature.<sup>195</sup>

Media scrutiny of board affairs also contributes to board sensitivity and accountability. Media reports of board actions, of member qualifications, conflicts of interest, and attendance at board meetings, and of the financial condition of the pension fund can provide valuable information to taxpayers and public

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management, performance, and results of public endeavor; the effectiveness, efficiency, economy, and productivity of public endeavor; and the honesty, integrity, and fidelity demonstrated in the conduct of public endeavor." B. FRIEDMAN, *THE QUEST FOR ACCOUNTABILITY* 38 (1973).

193. For a review of the relative merits of an appointment process versus an election process, see N. HAMILTON & P. HAMILTON, *supra* note 19, at 121-23 and the authorities cited therein.

194. *See id.* at 124.

195. *See id.* at 123.

employees. The statute, therefore, should mandate open board and committee meetings, with appropriate executive session exceptions, and require the disclosure of board resolutions, minutes and studies to facilitate media coverage of the board's performance.<sup>196</sup>

Another accountability measure the statute should require is a periodic audit of the board and plan fund.<sup>197</sup> Providing for financial audits by a related government agency, such as the state auditor's office, is inadequate for several reasons, however. First, the state auditor's office often lacks the budget, staff, and expertise to deal thoroughly with the unique characteristics of the public pension fund organization.<sup>198</sup> Second, since the state auditor is often represented on the retirement board, an audit by a board member will not appear, and quite possibly may not be, completely objective.<sup>199</sup> Third, because the state auditor is an elected official, there is potential for use of the pension auditing process as a stage for politically motivated actions and statements.<sup>200</sup> The pension statute should require that a qualified external independent auditor perform an annual audit. The audit should include a study of board

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196. The United Nations Report discusses the problem of public enterprise accountability and concludes:

The evaluation of the work of public industries remains a complex matter of judgment, involving the balancing of many factors. The best advice that can perhaps be given at the present time is to make sure that those charged with responsibility for running each industry devise as many measurements of work performance, unit costs, and so on, as possible, and that the results produced are made public regularly and as frequently as possible. In this way the legislature, the executive, the press and the politically alert sections of the public will have the maximum amount of information on which to form judgments, and on which to develop searching and health [sic] criticism of those in charge of the enterprise.

United Nations Report, *supra* note 55, at 64. Similarly, Friedman states that "[t]o be *answerable* is to generate and to supply information. To hold others *accountable* requires that information be available as a basic foundation for judgments." B. FRIEDMAN, *supra* note 192, at 2.

197. The Pension Task Force Report states:

The lack of an independent review of public pension plan financial and actuarial matters carries an attendant risk of financial miscalculation or abuse. In regard to the need for independent review, public pension plans cannot be viewed differently from other financial enterprises including the sponsoring governmental employers themselves.

PENSION TASK FORCE REPORT, *supra* note 8, at 70.

198. *Id.*

199. This problem is eliminated in the proposal since, as an elected official, the state auditor would not be permitted to serve as a board member. See *supra* note 182 and accompanying text.

200. See *supra* note 182 and accompanying text.



structure and procedures as well as the accounting records of the board and plan funds.

Judicial review offers a third means of holding the board accountable.<sup>201</sup> Such review can take the form of a mandamus or declaratory judgment action. Another form of judicial review is the imposition of civil liability on board members through tort law<sup>202</sup> or the law of trusts.<sup>203</sup> The statutory scheme should clearly authorize judicial review of board activities through such legal actions.<sup>204</sup> To avoid any doubt, the statute should categorize board members as fiduciaries subject at least to common law fiduciary duties and liabilities.

Those who are directly affected by board action should have standing to institute appropriate legal action against the board and its individual members. Clearly, the attorney general should have standing on behalf of the state's taxpayers. In addition, taxpayers should have standing in their own right. Furthermore, the statutory scheme should grant contract or property rights in plan funds to plan participants and beneficiaries to provide them with a significant legal interest which can serve as their basis for standing to invoke judicial review of board performance.<sup>205</sup>

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201. For a discussion of the forms of judicial review and the limits of such review due to governmental immunity, see N. HAMILTON & P. HAMILTON, *supra* note 19, at 125-28 and the authorities cited therein.

202. See, e.g., K. DAVIS, *ADMINISTRATIVE LAW TEXT* § 26.01 (3d ed. 1972). See generally *Civil Liability of Government Officials*, 42 *LAW & CONTEMP. PROBS.* 1 (1978).

203. See *RESTATEMENT (SECOND) OF TRUSTS* §§ 197-226 (1959). See generally Note, *Personal Liability of Directors of Federal Government Corporations*, 30 *CASE W. RES. L. REV.* 733 (1980) (discussing appropriateness of analogy of personal liability of private corporate board members to members of governmental boards with profit-maximizing goals).

204. See, e.g., *Employee Retirement Income Security Act of 1974*, Subtitle B, Part 4, 29 U.S.C. §§ 1101-14 (1976). "The absence of a codified, substantive standard of conduct to which the fiduciary can be held frequently precludes recovery by the plan or its aggrieved participants." *PENSION TASK FORCE REPORT*, *supra* note 8, at 189.

205. The view persists that public employee pensions are gratuities. For example, in *Christensen v. Minneapolis Mun. Employees Retirement Bd.*, No. 768716 (Dist. Ct. Jan. 14, 1982), the state district court held that public pensions are gratuities and thus denied relief to a retiree whose retirement checks were cut off by a 1980 statutory amendment which retroactively increased the service requirement for pension benefits. In *Trustees of the Minn. Pub. Employees Retirement Ass'n v. Minn. State Bd. of Inv.*, No. 452938 (Dist. Ct. Jan. 22, 1982), the district court dismissed the plaintiffs' complaint which alleged negligence and breach of fiduciary responsibilities by the defendants. The dismissal was based in part on a finding that the plaintiffs had no standing to bring the action. The plaintiffs included an active plan participant and a retired plan member, both claiming property, beneficiary and contractual rights in the fund monies. Defendants argued with respect to these plaintiffs that they lacked standing to

## V. CONCLUSION

Public employee retirement systems were created to provide public employees with income for retirement. Most systems accumulate and invest funds to reduce the cost to taxpayers of providing timely payments of promised benefits to retirees. Thus, from the point of view of plan participants and beneficiaries as well as taxpayers, public employee retirement systems are financial ventures. Governmental control of public retirement plans should seek the maximization of financial return on the investment of fund assets within a risk level which is appropriate to the fulfillment of the financial purposes of the pension system. In short, efficiency in the selection of an investment portfolio should be the sole objective of pension fund regulation. The pursuit of other social goals, including the production of nonfinancial benefits for retirees, through the regulation of pension funds produces significant administrative problems, the potential for arbitrary regulatory action and special interest group dominance, and hidden subsidizations of others by plan beneficiaries and taxpayers.

The legal, economic, organizational and procedural framework in which governmental regulation operates should encourage and assist regulators in fulfilling their control objective. Although a regulatory framework cannot absolutely guarantee that the regulators in fact will fulfill this objective, it can significantly impact the likelihood of success. At the heart of the regulatory framework proposed in this Article is the proposition that regulators should be charged with the responsibility for creating and maintaining the conditions necessary for the efficient management of plan funds. Thus, the retirement board should be required to formulate and articulate investment policies sensitive to the legitimate interests of plan beneficiaries and of taxpayers, who are ultimately the plan sponsors. In order to obtain proper implementation of its policies, the board should 1) translate policies into operating objectives capable of performance measurement; 2) select competent external management; 3) impose competitive pres-

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sue since public pensions are gratuities. Memorandum in Support of Defendants' Motion to Dismiss at 11-13, *Trustees of the Minn. Pub. Employees Retirement Ass'n v. Minnesota State Bd. of Inv.*, No. 452938 (Dist. Ct. Jan. 22, 1982). MINN. STAT. § 353.38 (1980) states that "[n]othing done under the terms of this chapter . . . shall create or give any contract rights to any person . . ." See Note, *Public Employee Pensions in Times of Fiscal Distress*, 90 HARV. L. REV. 992 (1977) for a review of the case law regarding the legal status of public employees' pension rights.

asures on management; 4) communicate with management; 5) monitor and evaluate management's performance; and 6) implement appropriate responses to management's performance. This Article has also proposed statutory provisions to help ensure that board members will be competent, well motivated, independent, efficient and accountable. It should be noted that many of these principles are relevant to the formulation and implementation of policies relating to contributions and benefits, as well as to investments.

Modification of existing public employee retirement systems in accordance with the proposed regulatory framework would constitute a significant step toward meaningful and effective governmental regulation of public pension funds. This step ultimately should achieve the purpose for which public plans were first created—providing public employees with defined financial retirement benefits at the least cost to taxpayers.